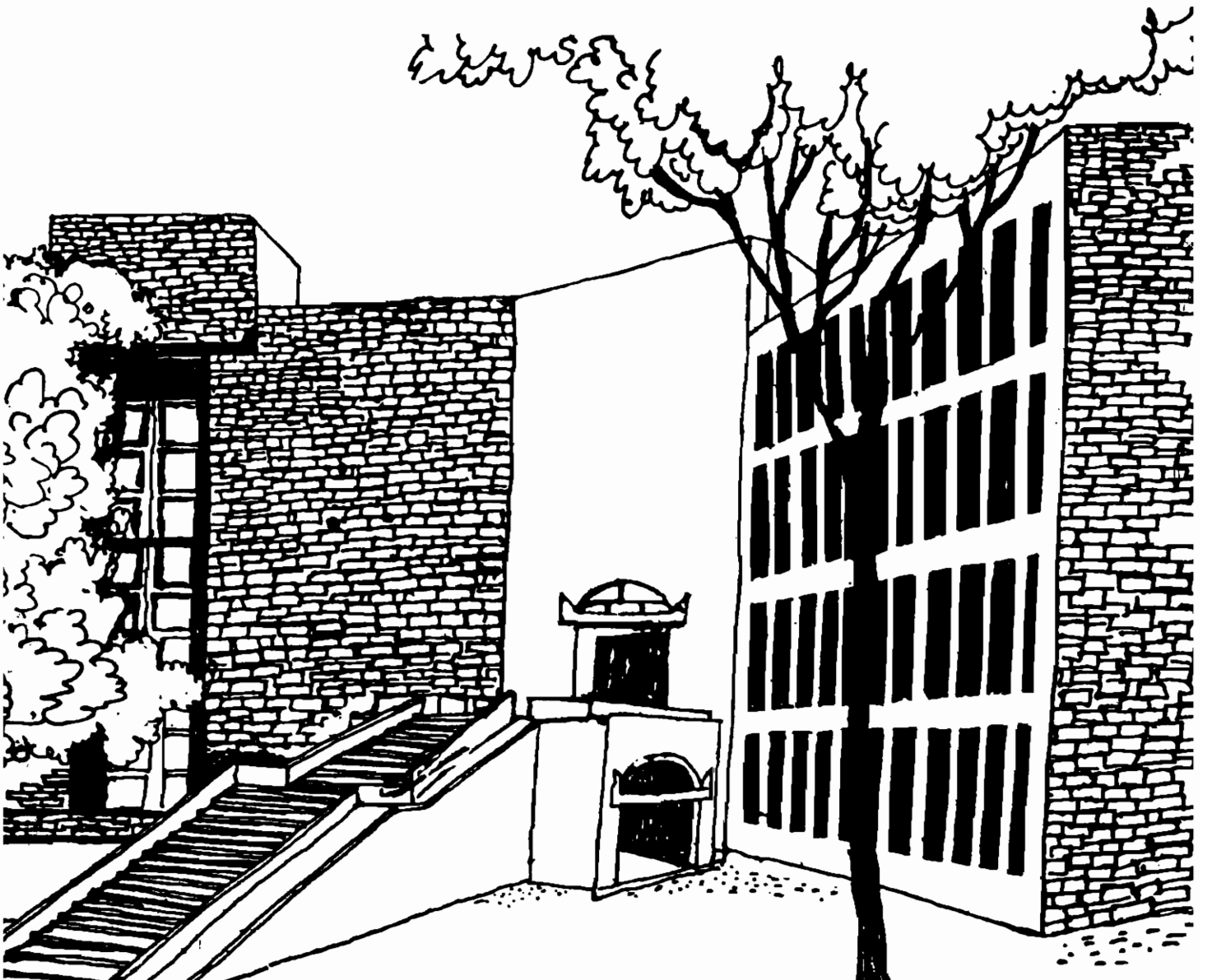




Working Paper



OPPORTUNITY CREATION AND THREAT PERCEPTION:
FOCAL FACULTIES IN THE AVIATION CONTEXT

By

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Abstract

The new civil aviation policy may be controversial because it marks a historic shift from potential intra industry sources of foreign investment to trans industry sources (as distinct from purely financial consortia). This sets the stage for observing the unfolding of focal faculty theory in actual management practice especially at the regional level. Under this theory, there are no insuperable barriers to entry in the long run but only barriers to profitable imitation in the short run. In this paper we review some recent approvals granted to airline proposals to observe if there is any discernible movement in the predicted direction. Examples were found both at the national and regional levels. The brief review did not uncover evidence of radically innovative entry strategies by foreign players. Perhaps its just a case of “early days”. The examples identified involve actual aviation industry players engaged in well-known strategies of vertical integration or apparent positioning for horizontal integration at an appropriate time. While airlines seem to be manoeuvring at the upper (national) level, aircraft manufacturers/distributors seem to be active at the lower (regional) level. Even so, prospects for a transformation of Indian aviation over 10-15 years are fairly certain. Two test cases for focal faculty theory were also identified. Oddly enough these were existing (or interested) firms which are required to divest the foreign airline stake in force (or contemplated). Who are the aviation savvy, yet “non-aviation” investors who will take up these stakes for the long term - financial investors or focal faculty investors ? And, internationally, does this qualify as “liberalisation” (pseudo or quasi)? Is conventional liberalisation required to achieve take-off in the aviation sector? The paper concludes with a brief discussion of an approach to monitoring the “aeropolitical” skyline for opportunity creation and threat perception. An appendix outlines the global aviation scene in terms of past experience with regulation, deregulation and liberalization.

Opportunity Creation and Threat Perception: Focal Faculties in the Aviation Context

Lately, civil aviation policy has been very much in the news. The debate has centred on a critical change announced in January and ratified by the Cabinet soon after. The provision for foreign minority investment, espoused during the hey day of economic liberalisation in 1993, was retained. But foreign airlines and airport authorities were abruptly disqualified from consideration.

Needless to say, this marked a drastic change from 50 years of policy emphasis on **intra industry** sources of foreign equity. However, with a change in prime ministership, there came a public expression of “dissatisfaction” with aviation policy from the new incumbent, Mr.I.K.Gujral. Even since there have been rumours about the impending modification of the foreign investment guideline.

These development led us to predict that the strictures against investment by regular aviation players, if sustained, would provide an opportunity to observe the unfolding of focal faculty theory in actual practice in the form of “innovative international competition” i.e. from non-aviation firms. According to this theory, the product market characteristics of a corporate portfolio are more or less transitory manifestations of a few enduring (focal) faculties. Besides, there are no insuperable barriers to entry in the long run but only barriers to profitable imitation in the short run. And leveraging focal faculties in the long run is more economical than the instant investment of hard cash. Hence, in

theory, a non-aviation firm which shares some focal faculties with aviation could leverage resources over a 5-10 year period to enter and transform the Indian aviation business whose attraction as a key part of the fast growing Asian market is unmistakable. Thus, inadvertently, the intra industry approach to foreign investment may be giving way to an experimental trans industry perspective. We also predicted that focal faculty development would be visible particularly at the level of smaller regional carriers, the “hedgehoppers” and “puddle jumpers”, since the policy seemed to favour the import of small aircraft. Since some proposals have been approved under the controversial policy, we have reviewed those with an international corporate component to observe if there is any discernible movement in the predicted direction. In the process, we hope to demonstrate an approach to monitoring focal faculty based competition for future opportunities. In addition, *Appendix I* provides a brief background of the global aviation scene in terms of regulation, deregulation and liberalization.

National Level

Lufthansa’s international cargo operation, a joint venture with the Hindujas is one successful proposal. The idea is to connect 15 Indian cities with Sharjah, Lufthansa’s cargo hub in the Middle East since twelve airports, including the four metros, already have some international traffic. The resulting cone shaped route structure basically lies in the international arena and seemingly poses no threat for domestic players in passenger operations.

But **what if** the base of the cone is inter-connected? A domestic route structure could, conceivably, be added to the international one albeit over a 5-10 year period. Two conditions would of course, have to be met, the all-important one being the liberalisation of aviation policy in the meantime. The other, however, is already within the ambit of international aviation practice and involves the use of so-called “quick change” aircraft. These are Boing 727s which can be re-configured rapidly for carrying passengers and back again for cargo by trained ground staff according to established schedules. Thus Lufthansa may have strategically positioned itself for a possible horizontal move into domestic passenger services at the appropriate time.

Some credence to this line of thinking is provided by arch-rival British Airways (BA's) reaction. BA has recently petitioned to expand its existing stations from 4 to seven. When connected together under the necessary liberalised policy regime, with the necessary local partner, BA could offer competition to Lufthansa's local network just as Deutsche-BA does in Germany. One can question whether positioning in anticipation of liberalisation is prevalent in global aviation. Further investigation may be required. But the point is, where there is a will there is usually a way. In this connection, a brief look at the North American scene may be of interest. Ever since its privatisation a decade ago, BA has been trying, unsuccessfully to establish operations within the US to counter the advantage American carriers enjoy on transatlantic routes due to their domestic hubs. BA's advantage of dominating Heathrow Airport slots translated into superior service. BA had a tie up with United Airlines and later succeeded in securing a 25% stake in US

Airways but for unknown reasons both arrangements were ended and it is now proposing a tie-up with American Airlines instead, with approval of the mega-alliance being subject to bargaining over access to Heathrow slots for US competitors. KLM which also secured a 19% stake in Northwest Airlines 5 years ago is now rumoured to be contemplating a sale due to the contentious issue of management control. These matters seem to vaguely parallel the Indian experience with Tata-SIA.

Regional Level

While the foregoing observations may have a speculative element in them, more concrete developments seem to have occurred at the level of smaller Indian carriers. Take for example, the case of Saab (U.K's) proposal for Deccan Aviation. Swedish in origin, Saab (which stands for Swedish Aircraft AB) makes turbo prop planes for regional carriers and appears to be one of the smaller players in this rapidly growing global business. Its Indian joint venture may be a simple case of forward integration i.e. from aircraft manufacture (and leasing) to passenger carrier, presumably for the first time in its corporate history. Only time will tell if this forward integration is, in effect, a case of focal faculty based diversification for Saab.

Saab's move into India may not be a casual one either. It is a leading contender in HAL's search for a partner for manufacturing 50-seater aircraft. Besides, IA has shortlisted the Saab 2000 turbo-prop for its immediate requirement of six aircraft in the North-east sector. Reportedly a French aircraft enjoys an edge due to extraneous

considerations but this has been duly denied. Nevertheless, it would seem that Saab is here for the long haul. Indeed, Deccan Aviation has already broadened its base by getting permission to offer chartered helicopter services.

Close on the heels of the Saab move, Beech Aircraft Corp. of the U.S. is also emerging as a significant player. A maker of even smaller planes than Saab, Beechcraft is contending for IAF's order for such equipment for VIP movement and related purposes. Beechcraft are also the mainstays of Pune based Span Aviation and Baroda based Gujarat Airways. Both run passenger services in western India. Beechcraft's sole distributor in India has now taken control of Gujarat Airways and plans to induct more planes to expand services to Rajasthan and Maharashtra. Although all this apparently falls outside the purview of the aviation policy guidelines on foreign investment, Beech Aircraft happens to be a unit of Raytheon, an electronics and construction corporation, which is active in Indian airport modernisation projects and, hence, must be considered another long term player.

This brief review has not uncovered evidence of radically innovative entry strategies as anticipated when the restrictive policy was announced. The examples introduced involve actual aviation industry players engaged in well-known strategies of vertical integration or positioning for horizontal integration. While airlines seem to be manoeuvring at the upper (national) level, aircraft manufacturers/distributors seem to be involved at the lower (regional) level. Perhaps it's just a case of "early days". Even so,

the prospects for a transformation of the Indian aviation scene, both on trunk routes and regional ones over the long run, are fairly clear. Indeed, if concerted efforts are made at all levels and in all related spheres, there is no reason why aviation cannot become a pervasive **societal faculty** for India just as aerospace is in the U.S

Test Case(s)

But to return to our search for current evidence of focal faculty leveraging, it seems that, oddly enough, Jet Airways is shaping up as the sole test case. Perhaps the only successful new entrant in Indian aviation so far with 25% of the market, it is required under the new policy to divest the 40% stake, held by foreign airlines since its inception, within 6 months i.e. by October 1997. Indications are that such divestment could occur by August. In addition it has to replace its chief operating executive, a foreigner.

The point is, who is the aviation savvy, yet “non-aviation”, investor who will take up the stake for the long term? Note that even **indirect** holdings by the present foreign airlines are not allowed. So conveniently “parking” the equity in shell organisations with complex cross-ownership may not withstand serious scrutiny. This could constitute a “wait and see” option which is reversible should liberalisation materialise somehow. The other two options are either to find a pure financial investor or a focal faculty investor. In the case of the former, would an “aviation fund” run by global financiers qualify as a non-aviation source? Moreover, what would be the long term strategic intent of a focal faculty investor now that Jet Airways is sufficiently well-established on domestic routes?

In fact, it is reportedly planning to expand internationally, albeit to fairly nearby destinations to minimise the impact on Air India's profitability. Among the benefits, in focal faculty terms, is the potential of developing a critical retaliatory capability against international players who may apply competitive pressure when they eventually enter the domestic sector. Hence, Jet Airways strategy does seem to bear watching.

It has recently been reported that Tatas have finally accepted the possibility of going "solo" in the domestic airline project. It is not clear if a replacement is being sought for SIA's 40% stake. Thus Tata Airlines may also be a test case for our purposes similar, in some ways, to Jet Airways. SIA, meanwhile, is interested in expanding its Indian network by adding three southern stations to the existing ones in Delhi, Bombay and Madras just as BA and Lufthansa seem to be doing, as observed earlier.

Scanning the Aero-political Skyline

The aviation sector is clearly heading for "interesting times". It is not clear if Indian aviation policy constitutes "liberalisation" (whether quasi or pseudo) and if conventional liberalisation is unavoidable. (See *Appendix I*) But regardless of what actually happens it is necessary to develop an approach for monitoring focal faculty based competition for opportunities on the "aero-political" skyline. Four basic principles can be briefly outlined. First, a specific viewpoint has to be articulated however tentatively. Second, the innocuous incident should not be ignored. Details of all relevant events have

to be journalised and (dis)confirmation continuously sought on the broadest possible canvas. The collected information has to be consolidated periodically and the necessary connections established among the details. Third, one has to watch out for evidence of competitive dynamics at various levels in order to sharpen the perspective. Finally, make mental notes of and follow up on events slated to transpire in due course to establish the necessary future outlook.

If all members of an organisation are able to engage in this process actively and share their ideas then competing for future opportunities would become a reality in the firm. Goods producers would also become knowledge leaders - firms with focal faculties.

Appendix I

Aviation Policy: A Global Perspective

Regulation

The transportation sector, starting with railroads in the 19th century, was among the first to attract the economic regulation of prices and services. In 1938, when several airlines were already in existence, the U.S. established the Civil Aeronautics Board (CAB) to ensure safety standards and alleviate the cut-throat competition associated with the Great Depression. The CAB took an innovative approach to regulation by adopting a developmental focus keeping in mind the highly dynamic nature of the industry. It assigned a mix of profitable (high density) and unprofitable (low density) routes to carriers, and set standard fares for minimum levels of service. This led to cross-subsidisation between a carrier's markets and competition based on service levels. In an attempt to protect the credit standing of the industry as a whole, CAB approved mergers of financially troubled players with stronger ones in the aftermath of perennial capacity wars due to technological change in aircraft. In this way, the number of trunk carriers during the 40 years of CAB regulation did not increase at all but, instead, decreased. CAB did encourage local service carriers to enter the industry in the 1940s and 1950s. It applied the criterion of "fit, willing and able" to evaluate proposals subject to the degree of "public convenience and necessity". The subjectivity of the latter may have provided a cloak for denials based on fears of impairing existing carriers' profitability. But no one could say for sure. At any rate, government's decisive say in aviation management was undeniable. Its relationship

to the industry was characterised as “familial” with elements of both control and protection. But consumer interests suffered because cost increases had to be borne by them to ensure adequate returns to the carriers. In the interests of “knitting the federation together”, commuter services using small aircraft were exempt from CAB regulation.

International aviation was outside the CAB’s formal jurisdiction. Negotiations were conducted by the State Department in the President’s name. The aim was not only to promote tourism and international trade and investment but also to maintain strategic links with far flung colonies. Foreign airlines were encouraged to serve the US but were limited to border/coastal cities and intercity/domestic services were not allowed. Bilateral Air Services Agreements (ASAs) provided the basis for international aviation for decades.

The CAB’s stance vis-à-vis airline diversification and new entrants from other industries is of interest. It steadfastly disallowed surface transport carriers from entering aviation though steamship companies, in particular, showed keen interest from the very beginning. By the same token it seemed to frown on any contemplated diversification by carriers into other industries on grounds of blurring their focus though this might have helped to stabilise erratic profitability patterns.

Deregulation

In the 1970s a view gained ground that the barriers to entry and exit in aviation were low. Hence deregulation was advocated so that free competition could prevail. Part

of the argument was based on experiences in certain intrastate markets (Texas and California) which had never been regulated by CAB and where cost control had been emphasized by State regulatory authorities in the interests of lower fares. From 1978 a process of deregulation was set in motion to be completed by 1985. Price competition came into force, new applications were approved by the lame duck CAB without fears of impairing existing carriers' financial condition and a subsidy program was introduced to guarantee essential air services to small communities for 10 years. Safety matters continued to be the concern of the Federal Aviation Administration established in 1958 especially in relation to commuter airlines. The entrepreneurship unleashed by deregulation was largely confined to short-haul routes. Although deregulation brought many benefits, it also stimulated interest in some form of re-regulation. For example, passenger comfort seemed to have been sacrificed for reasons of economy. Besides, the link between domestic operations and international ones had increased in importance. Government's role in international negotiations could not be easily renounced. Hence the CAB's powers were transferred to the Transportation Department in late 1984. A spate of buying and selling ensued resulting in an increase in industry concentration. By 1988 only 8 airlines controlled 92% of US traffic (US 80% in 1978) and operating problems were numerous in the areas of staffing, scheduling and baggage handling. For example, Northwest Airlines was dubbed "Northworst" by complaining passengers. While a couple of hundred new commuter airlines took off, even more folded up, resulting in a net decline in commuter firms. But the overall aviation market grew.

During this time of American deregulation, the British had embarked on a similar route. British Midlands a tiny airline campaigned for deregulation in the 1970s and succeeding in entering some main routes in 1979 in competition with British Airways (BA). By the mid-80s, BA itself began to be prepared for privatisation which materialized in 1987. It changed remarkably from a stodgy state owned airline to a highly dynamic and profitable international carrier. Britain also spawned a new breed of airline company typified by Virgin Atlantic Airways which began with the licence of the defunct cut-price Laker Airways. Itself a diversification from the retailing of recorded music, Virgin became the nucleus of a highly diversified group with interests in transportation, travel, computer services, financial services, soft drinks, etc. Meanwhile, BA had vigorously embarked on outsourcing “non-core” activities to reduce costs in anticipation of growing international competition. It had also started diversifying e.g. into mail order film processing and camera sale in collaboration with a specialised photographic company. The mail order materials were distributed with the plane tickets.

The experience with deregulation seems to show that even though barriers to entry may be (nominally) low, the barriers to profitable imitation in the short run e.g. of model airlines such as Southwest (in the US), BA and Virgin are high and a (rapid) competence building approach may be inescapable for new players in the aviation industry.

Liberalisation

To understand trends towards liberalisation it is necessary to touch upon the “five freedoms” of international aviation regulations. These pertain to rights to overfly, emergency landings, charter operations, services for home country nationals and, finally, to carry third country traffic. Changes seem to be occurring at the levels of the fourth and fifth freedoms. Bilateral ASAs are being scrapped in favour of “open skies” deals lifting all flight restrictions between country pairs. A sixth freedom seems to be slowly taking shape viz. the freedom to operate domestic services in a foreign country. Hence liberalisation can be viewed in terms of the following four categories: global deregulation, conventional liberalisation, quasi liberalisation and pseudo liberalisation.

Global deregulation can be used to refer to open skies deals, such as those between the US and many European and Southeast Asian countries. Japan is resisting an open skies deal because it has created an intricate domestic network and is developing its hubs to serve other Asian regions. The US, however, doesn't want to be limited to the role of transpacific feeders to the Japanese hubs.

Conventional liberalisation pertains to freedom for foreigners to control domestic airlines. None of the major aviation markets seem to allow this currently. The US allows a maximum of 49% equity with voting rights vested to a 25% limit. The EU seems to have gone the furthest in this direction, that too with effect only from April 1, 1997. EU airlines are allowed to hold up to 49% equity in the domestic airlines of EU countries. If

the EU is treated as one entity then the situation is not very different from the U.S. The latter cites "union opposition" to foreign airlines entry such as that sought by B.A for years.

Quasi liberalisation refers to the phenomenon of "alliances" between airlines of different nationalities, a "second best option" in the absence of conventional liberalisation. Currently the biggest such grouping is of United Airlines (US), Lufthansa (Germany), Thai (Thailand), etc. British Airways' proposed alliance with American Airlines would overshadow even this. Alliances basically involve operational co-ordination via code sharing, baggage handling, etc.

Pseudo liberalisation refers to the Indian formula whereby foreign investment is allowed but only by non-aviation players. Airlines are especially excluded. This leaves the option of either attracting purely financial investment which is not easy for airlines or focal faculty investment from those cash-rich companies wanting to diversify into passenger airlines without a business base in aviation. The key issue here is whether pseudo liberalisation with its bias for innovative international competition will be considered by aviation policy makers world-wide (especially those in the US and Japan) as having the long term potential to transform the industry globally or simply a half-way house to prevailing forms of liberalisation. Perhaps a lot depends on whether a clear line can be drawn between aviation and non-aviation.

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