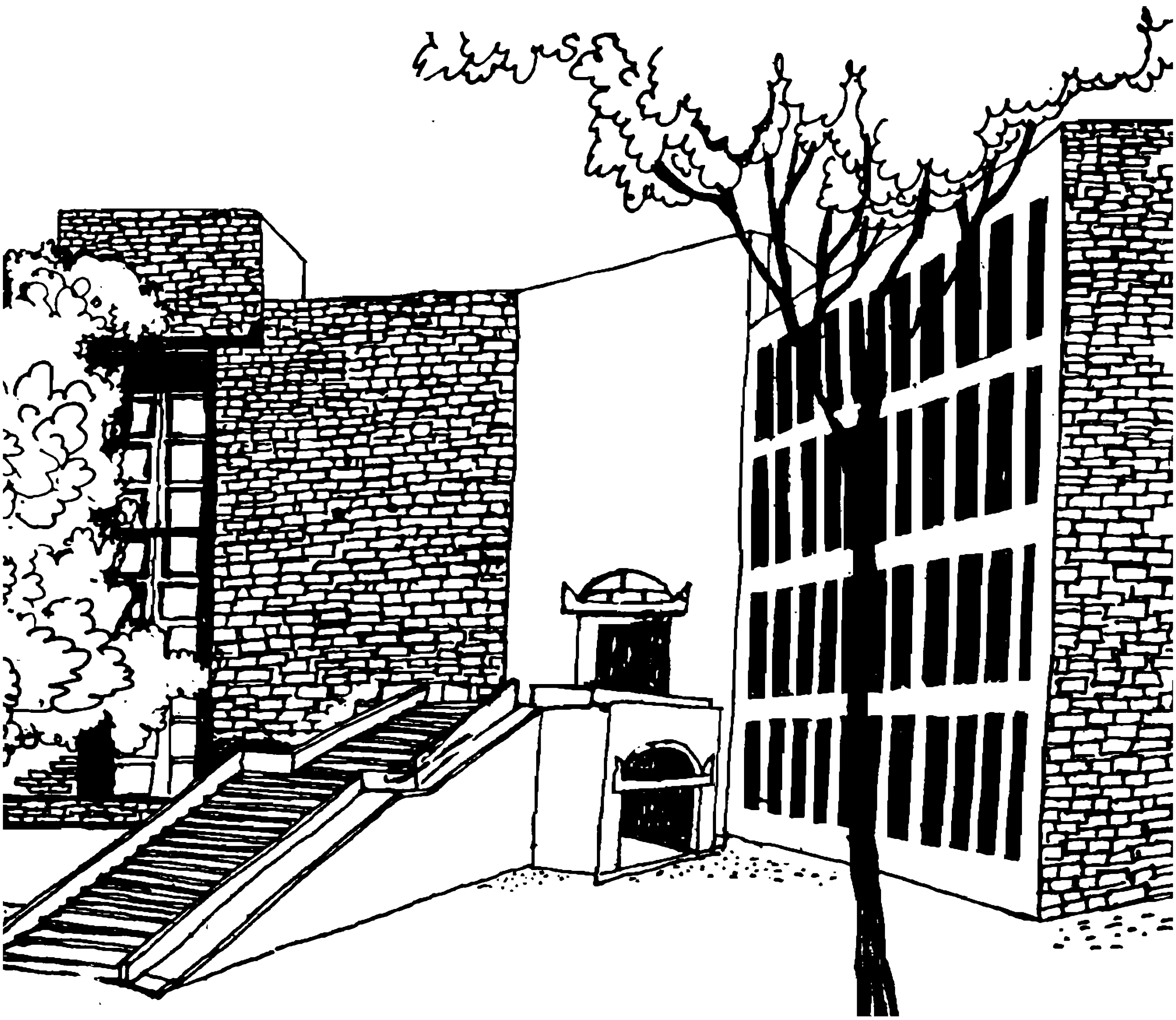
विद्याविनियोगाद्विकासः
IIM
AHMEDABAD

Working Paper



PUBLIC POLICY FOCAL FACULTIES AND INNOVATIVE INTERNATIONAL COMPETITION: THE CASE OF INDIAN CIVIL AVIATION

By

P.S. Thomas
T. Madhavan

W.P. No.1361
March 1997

The main objective of the working paper series of the IIMA is to help faculty members to test out their research findings at the pre-publication stage.

INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD - 380 015
INDIA

ABSTRACT

In the early 1990s the concept of the firm's focal faculties came into vogue. It helped to explain the phenomenon of innovative international competition. In the new civil aviation policy of the Indian government we have an interesting situation where there is some scope (perhaps small) of seeing an innovative international competitor. This is because the new policy has explicitly opened the field to foreign investment but simultaneously disallowed existing global players in the industry from investing. Thus, aside from foreign financial institutions and investments by NRI entrepreneurs, there is the hitherto unrecognised possibility of a non-aviation corporation leveraging its focal faculties to enter the Indian aviation scene. The paper is a preliminary attempt to shed light on the focal faculty concept by examining its applicability in an intriguing Indian situation with global potential. The Indian formula is recommended to the civil aviation authorities of developed countries who are also trying to protect domestic players. This raises the prospect of a serious worldwide evaluation of the focal faculty concept for management and development.

Public Policy, Focal Faculties and Innovative International Competition: The Case of Indian Civil Aviation

Currently the Union Cabinet is considering a new civil aviation policy. The most surprising thing about it is the proviso regarding foreign investment. It allows foreign entities to hold up to 40% of equity in Indian carriers. But they should not be engaged in the airline/airport business! This led the Economic Times to editorialize: "If the potential foreign investor has any expertise in aviation, the Civil Aviation Minister would not let him invest in the airline business. This is perverse. He wants India to be the only country where expertise is a disqualification for investment".[1] As the Business Line's headline quipped: "Money yes, merit no".

Almost all other media pundits in India and abroad have also stressed this point in their commentaries. But there are two sides to expertise. One is the application of expertise which commentators seem to have focused on so far. The other, which is poorly articulated in the new policy and which may have been overlooked by observers, is the development of expertise. The proposed policy with its provisions for additions to capacity and aircraft imports is apparently seeking new entrants who are interested in building expertise over the long haul, starting at the provincial level. Thus it disallows foreign aviation investment directly or indirectly but seems open to innovative international competitors.

---

[1] All citations of Indian financial paper editorials are of the January 28, 1997 editions.

Our purpose is not to analyse the new policy or to assess the players affected by or involved in it. It is merely to view the issue of expertise from a management perspective to highlight a much talked about but little used concept viz. focal faculty theory which came into vogue recently and which seems surprisingly opportune in the present aviation scene.

Focal Faculties

Even when the concept of strategy was introduced some thirty odd years ago the emphasis was on the application of expertise, the so-called "distinctive competence" of the company. The idea that competence could be (and had to be) developed was primarily the contribution of Japanese firms operating in highly competitive (and lucrative) international markets. Sony pioneered the transistorization of consumer electronics and now dominates it. Along with JVC and Matsushita it created the altogether new VCR market after a steady 20 year effort. Meanwhile Fujitsu, Hitachi, NEC and Toshiba developed what we call focal faculties[2] in semiconductors and integrated circuits. Over a decade they dislodged the Americans from memory chips and thus cemented their own positions in the full range of computing from supercomputers to laptops. Many such examples of the sustained development of expertise to turn the tables on industry leaders are cited periodically. Such "oaks from acorns" stories form the basis for

[2] P.S. Thomas and T. Madhavan (1996). "The Focal Faculties of the Firm: Using Knowledge Power for Global Leadership". IIMA Working Paper No. 1344 (Dec).

focal faculty thinking which is the nearest corporate equivalent of advancement based more on merit rather than money.

The focal faculties of the firm are simply those company specific, knowledge based managerial "dynamos" which can be leveraged, internally and/or externally to drive the organisation successfully from one generation to the next. But focal faculties are not to be confused with end products or core businesses. As prospects in particular product-markets change, focal faculties enable the firm to adapt to threats or seize opportunities in order to continue to thrive by developing new products or entering new markets. As the term suggests, the focal faculties provide an important measure of focus (the connecting threads) even for ostensibly highly "diversified" activities.

But a firm has to <u>invest</u> in its focal faculties both in terms of research (in its broadest sense) as well as application. Moreover, the research has to be done largely by the organisational members themselves rather than outsourced to specialists. In this way it enables the firm to accumulate "intellectual capital" and to exercise a perceptible measure of "intellectual leadership" in its industry. Hence the renowned management guru, Michael E. Porter, has observed recently: "Companies are going to have to become much more like universities than they have been in the past."[3] Two pre-requisites for this include: (1) a willingness and ability on the firm's part to function at or near the global productivity frontier of the industry and (2) the placement by society at large of a high value on the faculty development efforts of firms in global competition.

Aviation

What are the focal faculties of the aviation business? To the best of our knowledge this issue has not been addressed for public consumption so far except by Boeing which has recently listed them as (a) large scale integration of airworthy systems, (b) design and manufacturing and (c) the international travel scenario.[4] Basically it involves looking at critical success factors in broader "knowledge" terms rather than the narrower one of a mere "operator". Focal faculties are supposed to transcend particular businesses and they have to be distinguished from products and management functions (which Boeing does not seem to have been able to effect clearly so far) in their formulation.

For purposes of discussion we can suggest three focal faculties for aviation: (1) optimised capital asset handling (2) safety and security and (3) home and hospitality. These are associated

---

[3]. In Rowan Gibson (ed.) (1997). Rethinking the Future, London: Brealey.

[4]. In Business Week, Sept. 30, 1996.

with functionalities (or customer benefits) such as seat-mile availability, destination attainment and the 3 Cs (of comfort, convenience and competitiveness) respectively. But the central question of focal faculty theory is how these can be leveraged to enter new markets or businesses for future growth, in short for innovative international competition. Traditional types of vertical integration may not qualify as leveraging. For example a cement manufacturer taking a stake in a new airport may be a case of vertical integration rather than leveraging focal faculties.

In the context of the new civil aviation policy, the question has to be turned completely around: in which other (outwardly unrelated) businesses around the world are any of these focal faculties to be found? Note that vertical integration would be more transparent than leveraging in order to enter the Indian aviation sector and would face obstacles. Obviously faculty-based competitors would have to be in it for the long haul with some sort of "strategic intent" or fighting spirit underpinning the whole effort. Initially such operations would seem quixotic, defying conventional wisdom regarding aircraft acquisition terms, minimum efficient scales, airport suitability, employee motivation practices, customer targeting and service pricing etc. Over time, by redrawing industry maps in an acutely underserved sector on our international business frontiers, they might prove to be revolutionary.

Defending Domestic Dominance

This scenario would seem to serve the Ministry's purpose of protecting Indian Airlines from the sudden entry of potentially world class players. The reasons for defensiveness are well known. Indian Airlines is saddled with accumulated losses of about Rs.1000 crore largely due to the prolonged grounding of its state-of-the-art fleet of A-320s after one crashed shortly after their induction on Indian air routes. Secondly the rest of its fleet is old and fuel inefficient and is in urgent need of replacement at high capital cost. As a result of the foregoing and the prevalence of traditional adversarial attitudes between management and employees, fleet utilisation is sub par by international standards. Hence Indian Airlines lost a whopping 40% of market share practically in a matter of months to the new entrants in the Indian aviation scene after private sector participation was permitted in April 1991. Finally, as the Economist has put it, "Aviation is the last great industry tied to governments' strings the world over".[5] (This is particularly true for airports).

But for how long can IA be protected? The time available for revitalization may not be insubstantial. Assuming the present policy stands, it would take an innovative competitor about two years to start up and three years to breakeven and perhaps

---

[5]. M. Skapinker (1995). "Too many planes, not enough profit" in The World in 1996 (Economist Publication).

another 3-5 years to be poised on the threshold of transforming the Indian aviation scene giving IA a breathing room of about a decade, altogether. But strenuous efforts would have to begin at once and sustained over the entire period.

In the airline industry it is common knowledge that along with Singapore International Airlines, it is the erstwhile public sector British Airways which is setting standards. It is highly unlikely that British Airways which is the No. 1 foreign airline in the Indian market, is unaware of moves such as those by Lufthansa, SIA etc. vis a vis a crucial segment of the fast growing Asian market such as India even though presently it is pre-occupied with impending deregulation of the EU market and its mega-merger with American Airlines. In fact, BA had previously succeeded in elbowing SIA out of a proposed alliance with Qantas.

For its part, Lufthansa got its fingers burned in an Indian domestic airline joint venture. A number of aircraft leasing companies also faced problems in India. Kuwait and Gulf Air which are ostensibly minority shareholders in Jet Air, the only successful new entrant in the Indian market so far, would also have their strategic intentions (however unreasonable) to become global players on the strength of their experience in India. Hence Indian Airlines may have plenty to think about in terms of future competition although its current position is a bit better after the recent shakeout of new entrants. It cannot afford to delay putting its house in order and trying its own hand at joint ventures perhaps with a "natural" partner such as Air India (with which it has a common board) or, more adventurously, with foreign players, in suitable overseas markets.

In fact India's flag carriers may even want to "think the unthinkable" i.e. of providing "intellectual leadership" to the global travel and leisure industry by leveraging their focal faculties to enter unimagined businesses or markets at relatively low cost and investment far in advance of rivals. In short Indian aviation must also begin to think of providing innovative international competition in overseas markets. However, mere expansion of services and networks does not constitute innovation. Note that this is also not necessarily a frivolous option. Should the public sector airlines achieve the required global-level productivity improvements speedily then, according to focal faculty thinking, large sections of their staff will have to be redeployed rather than retrenched, if the cooperation of their militant unions is to be secured.

The Example of Virgin[6]

The experience of the U.K.'s Virgin group is of interest in this regard. The group was begun by Richard Branson as a successful mail order retailer of recorded music shortly after the repeal of

[6]. From Tim Jackson (1995). Virgin King: Inside Richard Branson's Business Empire. London: Harper Collins.

retail price maintenance laws. It entered aviation in 1984 when an opportunity arose to acquire the licence of the defunct Laker Airways (which ran a no-frills service called Skytrain across the Atlantic) and to offset anticipated start up losses against profits from the record business. Named Virgin Atlantic Airways, the new service started with one leased second-hand Boeing 747, operating between Gatwick, London's secondary airport and Newark, just outside New York city. A sudden slump in air travel after the American bombing of Libya nearly led to the collapse of the service in its very first year. But the subsequent boom in air travel enabled it to gradually expand its network globally and modernise its fleet consisting now of about 15 (mostly wide bodied) jets.

Lacking airline expertise at the outset, the new entity leveraged the appeal of the Virgin name with Branson's penchant for generating extremely valuable publicity at no cost through daredevil stunts such as breaking the record of Atlantic crossing in speed boats and flying over oceans in hot air balloons. The latter accurately reflected the extent of Branson's strategic intent. Branson also gave top priority to his employees' concerns spending much of his time on long transatlantic flights with them. On the pricing front, Virgin kept economy fares unchanged but charged business class fares for first class service thus providing high overall value for money. In fact

British Airways and some American players initially subjected Virgin to price pressures which it survived mainly because British Airways was diverted by its privatisation process which got underway around that time.

Virgin Atlantic was in the sky in four months from conception and in the black, financially, within 3 years of its launch. It entered into a code sharing (also known as "air-sharing") alliance with Delta of the U.S. and a crew sharing arrangement with Malaysian Airline System (MAS) in the eastern hemisphere. It also attracted equity investment (since liquidated) of a Japanese travel and leisure group, Seibu-Saison. Thus Virgin was able to ride out the longer recession of 1990-91 and firmly established itself in the world airline industry unlike some earlier British air services. The group's main travel unit now consists of the airline, a cargo service, a small-budget air service and a tour group. Besides there are units operating numerous hotels and clubs, cinema theatres, a chain of record shops, a pop music radio station, and a book business along with TV production, software development and an Internet service. Finally there is a personal financial services unit and an investment/development arm which has stakes in Eurostar (the futuristic Channel train service) and a seemingly archaic hot air balloon. All the units seem to be tied together mainly by the force of the flamboyant chairman's personality, the strength of the "Virgin" brand and the youthfulness and enthusiasm of the employees. One of Virgin's air hostesses is the managing director of a new unit and some staff have been seconded to Eurostar.

This may really be stretching the idea of "focused diversification" a bit by Indian standards of financial losses, union non-cooperation and government myopia. But it outlines the possibilities for innovative international competition. (Note that if the usually extensive "moon lighting" of employees in their individual capacities is considered the resulting business variety may be more of a match for Western style corporate diversification!).

Management Implications for Indian Aviation

From the foregoing it is clear that formulation of the new civil aviation policy though-perhaps inadvertently-innovative, represents only a small first step. The aviation and tourism authorities are faced with enormous challenges. Citing complaints in foreign media, the Observer of Business and Politics has editorialized: "The government is rebuffing foreign equity but not doing enough to salvage its own deplorable domestic airline situation" adding, "immediate steps should be taken to refurbish Indian Airlines and Air India". The Financial Express has effectively made the same plea.

We would go so far as to suggest that the government should urgently adopt a truly broad-gauged "strategic planning architecture" for aviation together with a strong emphasis on developing focal faculties while shedding "forgettable faculties". While Air India and Indian Airlines have a common board, tourism should also be included in the core of Indian aviation planning. The closely related areas of aircraft import/manufacture, petroleum import/production and general industrial development should also be carefully addressed. Finally, even the tertiary matters of road development, banking and finance, telecom facilities, electricity supply and improved sanitation should be dealt with as proactively as possible on a national scale by our public sector aviation planners.

The key point is that airline and tourism staff should fan out in teams to obtain the necessary information and formulate action plans rather than leaving it only to others. In order to realize this it would obviously be necessary to inculcate a new ethos in aviation of all being in the same boat (plane) and not pulling in different directions. Before anything, all must agree that the cherished "Indian Way" can - and must - change quickly for the better in the aviation sector. Employee ownership of 10-20% may be required (in exchange for assured labour peace and high involvement).

Focal Faculties and Public Policy

At the outset it must be admitted that focal faculty-type thinking may take time for our policy makers and top executives to digest. When the civil aviation ministry's scheme regarding foreign investment was first floated in October 1996 it reportedly caused "amusement" in policy circles. The Business Standard came closest to putting a finger on the underlying idea. But its editorial comment exemplifies the skepticism that one tends to encounter. As it put it sarcastically: "On the strength of the general principle that foreign equity should be allowed only in sectors where the foreign investor has no prior knowledge of the business, India's share of global investment flows could be expected to soar much higher than any still born airline". But, we believe it may be advisable to study the issue in greater depth before jumping to any conclusions.

A couple of instances can be cited to show the basis for this "flight of fancy". In the U.S., Johnson Controls, a leading supplier of automotive components has taken leases on or management contracts for four commercial airports as well as a couple of smaller ones for private jets. In the airline business itself, there is the British example of Easyjet, a no-frills start up run by a 28 year old. It seems to represent not only cross-subsidisation of funds but also perhaps the leveraging of focal faculties from his father's Greek tanker business. We have also alluded earlier to the, no doubt passive, investment (since liquidated) of Seibu-Saison, the Japanese travel and leisure group in Virgin Atlantic Airways. It must be mentioned that Seibu-Saison sold its 10% stake in Virgin in order to pick up Scandinavian Airlines' stake in the Inter Continental Hotels to which Seibu itself was heavily committed. Hence there do seem to be sufficient grounds for investigating the issue of "non aviation" interest in aviation in greater depth.

Focal Faculties and Innovative Competition in International Aviation

Currently the international aviation policy scene is in ferment what with calls from all quarters for "open skies" agreements. The U.S. deregulated its domestic aviation sector two decades ago. Though this attracted many new players, the 8-firm concentration ratio increased over a decade from 80.4% to 91.7%. This sector alone accounts for an estimated 40% of global volume. But it has not been liberalized so far. Meanwhile the EU is gearing up to de-regulate its airspace in 1997 while several EU members have entered into "open skies" agreements with the U.S. For its part, Japan allowed a discount travel operator to start a domestic airline in late 1996. Two smaller operators have also been given the nod in an attempt to bring down sky-high domestic fare structures. But Japan is resisting the further opening of its aviation sector to US players citing the closed nature of US domestic aviation which it believes allows the cross-subsidisation of transatlantic and transpacific flights of the country's carriers.

In the prevailing circumstances, the thought occurs that perhaps the "Indian formula" might provide a basis for progress in global "open skies" agreements. Is it feasible, perhaps under the aegis of a new World Aviation Treaty, to allow non-aviation players (in conjunction with other interests) to enter any aviation market subject to the defense of domestic dominance to the extent possible? If the considered answer is "yes" it might not only indicate that there is long term value in focal faculty thinking but also present a "killer application" (no pun intended) for transformation of the global travel and development scene over the next quarter century.