

# Unpacking the SAA operating context

## Strategic Concepts and Analysis

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# My credentials

- ▶ My exposure to air transport and civil aviation goes back to 1975 while I was in Lesotho
  - ▶ I've had high level interaction and involvement at the International Civil Aviation Organization for five years and was Vice President for the African Civil Aviation Commission for three years. I also underwent management attachment with Ethiopian Airlines.
  - ▶ A few years back I was engaged as advisor to Comair on a potential acquisition
  - ▶ I was Group Strategy Chief for Transnet up to end 1999 and my principal task was the unbundling, corporate reorganization and re-design of Transnet from a conglomerate into a Financial Holding entity with stand alone businesses. The current structure is a result of that effort.
  - ▶ I have been an organizational strategy consultant since then and regarded to be among the top tier in this field.
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# Request and expectations of the Committee

Comprehensive briefing on funding for SAA in the context of the government's fiscal objectives as per the 2017 Medium Term Budget Policy Statement, to include;

1. Comprehensive briefing and analysis of the South African aviation sector
  2. Options and conditions to consider for ensuring sustainable funding for SAA
  3. Options to consider for ensuring a competitive and sustainable SAA
  4. Key interventions required (sector wide and operational specific) for turning around SAA to profitability; and
  5. Any other matter that may assist the Committee....
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# Outline of the presentation

The questions you have raised are essentially about organizations in a complex system or systems. SAA is a complex organization/system, existing within another complex system, the operating context, within a state (also a system) in a regional and a global complex system. The state of the system/organization is determined by the interaction of various factors internally and externally.

No single factor can determine the success or failure of a system but it is the interaction of all the factors in the system that ultimately determines the fate of the system.

The questions you have raised reflect this understanding and I will try to make it as simple and comprehensible as possible within the tight time frame provided....



# Outline of the presentation...cntd

Airline business is traditionally expensive and it requires very expensive equipment. In the past it was primarily state airlines or flag carriers that participated in the industry under very tight rules that protected them from competition and thus creating an oligopolistic industry.

It has undergone transition over time to its current state of open and vicious competition. It is important to understand the drivers behind the transition, how it unfolded and the impact it has had on SAA. This is crucial to understanding its current crisis and how it can be solved.

## Structure:

- ▶ In the 1st two slides I'll try to emphasize the strategic concepts of organizational purpose; strategic vision and complexity of the operating context and how these are critical in determining existential success.
- ▶ In the slides that follow, I will take you through a historical perspective of air transport from pre1980 when the industry was highly controlled to its current state of total deregulation and open and aggressive competition
- ▶ I will track the performance of SAA throughout this transition and how it impacted its fortunes
- ▶ I will then review the history of ET to understand drivers for its success and what this may mean for SAA.
- ▶ Finally I explore how and why SAA failed to be competitive and what can be done about it

# SAA and the operating context

NB; (Universal Truth): *No organization exists without a defined purpose.....*

The starting point in strategy formulation therefore is to understand and articulate the short-term, medium and long-term intended purpose or value proposition and strategic vision for the organization from the perspective of the shareholders or owners.

Everything flows from this concept.....

- Intended market place
- Challenges and constraints in operating context
- Mitigation strategies
- Business model
- Organizational strategies
- Structure and human capital resources
- Funding structure
- Governance framework

Fundamentally: Is the Entity Fit for Purpose?

# SAA and the operating context

An important and universal guiding principle governing all organizations is that:

*“A critical function of management is to ensure that their organization stays resonant with the environment in which it operates otherwise it will face certain existential threat” .....*

The art of success is to adapt and stay ahead of change

My experience, expertise and forte focuses on assessing and helping organizations to identify key drivers or the dominant discipline required to successfully deliver the agreed value proposition and how to structure the entity to stay competitive in a complex dynamic and changing operating context.

# Step 1: Clarity of purpose is the first Task

If the purpose is to:

Run an airline on strict commercial principles that are consistent with market practices, then the implications become very clear and include the following;

- ▶ The governance framework and management practice must be consistent with market practice and comply with the Companies Act 71 of 2008 as well as the King Report on Governance for SA 2009(King III).
  - ▶ Operating costs must be minimized and the business must be self-sustaining....
  - ▶ Organizational culture of Professionalism must be aligned to support the commercial purpose.
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## Step 2: Clarity of purpose...cntd

If the purpose is to:

Run an airline on commercial principles consistent with market practices but that must also take into account the developmental interests of the State (public interest), then the response becomes more complex and risky;

Public interest factor introduces a political dimension .

- ▶ How does the political dimension affect management decision making in an otherwise viciously competitive business operation?...
- ▶ The role of the State must be clearly articulated in the MOI and shareholder compact but the independence of the Board must be sacrosanct
- ▶ Under such circumstances, a mind-set and culture of P-position; P-power and P-Privilege (Triple P) prevails. This is a dominant culture in the SOE's.....

# Context determines and shapes strategic choices... A global historical perspective..

1. Most air-transport markets were highly regulated at some point in the past because, apart from the USA, flag carriers were state owned and heavily subsidised
2. The Civil Aviation Boards have traditionally acted to protect incumbents from new competition and price wars, thus creating an oligopolistic structure in the industry.....(SA before 1996)

# Context determines and shapes strategic choices... A global historical perspective..

Globally, transformation in air transportation has occurred over four ten year cycles:

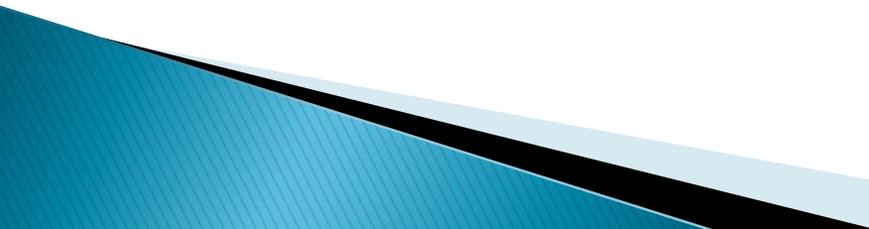
1980–90; In the USA, the Airline Deregulation Act of 1978 helped trigger the deregulation of the air transport market in the USA and led to the creation of innovations like the hub-and-spoke system, increased competition, discounted fares, and the creation of frequent flier programmes  
(more than 180 airline entered and exited the market)

1990–00; Geo-political realignment post 1989.

Unfair competition pressure from the USA against flag carriers.

Deregulation and entry of low-cost carriers.....Fifth freedom rights

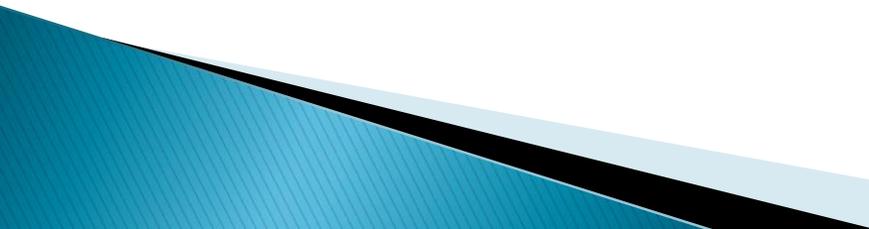
Technology advancements and innovation



# Context determines and shapes strategic choices... A global historical perspective..

2001–10; Collapse of legacy airlines from legacy costs  
Increase in competition from low cost carriers  
Realignment including mergers and acquisitions globally  
Price of oil; Jan 2000–\$25; Jan 2007– \$60; Jan 2010 – \$120  
Post 2008 global financial and capital markets collapse.....

2010–current;  
Innovation and improvements in aircraft technology  
High legacy operating costs  
Strength of the US Dollar and fluctuating exchange rates  
Rising price of oil  
Increase in competition from low–cost carriers



# SA historical perspective...pre and post-deregulation

1. As the flag carrier, SAA was protected from competition for over 40 years following the promulgation of the International Air Services Act, also known as the Air Services Act, Act No. 51 of 1949 (International Air Services 1949.....)
2. The Air Services Licensing Act, Act No. 115 of 1990 (Air Services Licensing 1990), finally and officially deregulated the domestic market in 1991 and restrictions on market entry and exit, capacity, frequencies, and tariffs were removed.
3. Only four airlines were active in the domestic market:
  - South African Airways (SAA) from 1934 (main routes and main airports)
  - Comair from 1945 (secondary routes)
  - Link Airways (later known as SA Airlink) from 1978 (secondary routes)
  - Bop Air (later known as Sun Air) from 1979

At the time SAA had >90% market of all scheduled domestic market

# SA historical perspective...pre and post-deregulation cntd...

Deregulation significantly lowered barriers to entry in the domestic market and increased competition led to loss of market share at the expense of SAA.

1. New entrants in the early 1990's included; Flitestar, Phoenix Airways, Sun Air, Comair and Nationwide.
2. Price wars were frequently waged
3. This benefited consumers but had negative impact on profitability for both new entrants and SAA
4. Flitestar went out of business in 1994; Phoenix Airways in 1995 and Sun Air in 1999.
5. SAA suffered severe losses in 1994 and in the period 1996 to 1998.
6. By 2000 only Comair, Nationwide and SAA remained.
7. On the international front airlines operating into SA increased from 20 in 1990 to about 62 in 1997!!

# SA historical perspective...pre and post-deregulation cntd...

The operating context for SAA changed dramatically between 1991 and 2000 and the fate of SAA was sealed during this period. The fundamental question is;

*“Did SAA do what was necessary and critical (restructure and reposition itself) for it to stay resonant to the dynamic and competitive context unleashed by the Air Services Licensing Act 1990?” .....*



# SAA in perspective....

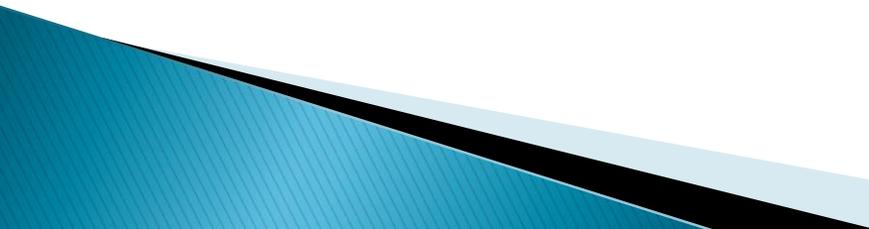
1. SAA concluded a three-tiered alliance with two new entrants, SA Express and SA Airlink in late 1993 to bolster its ability to compete effectively and provide an expanded service offering. This enabled SAA to establish a hub and spoke operations pattern.....
2. However poor management in the early 1990's caused internal decline flagged by; heavy operating losses, deteriorating working capital, rapid increase in debt and declining market share. This was driven by:
  1. Lack of strategic vision and focus
  2. Lack of depth and experience in the airline industry
  3. Poor financial control
  4. Poor strategic choices
  5. Lack of accountability
  6. Beaucroatic culture. The Triple P mind-set!!
  7. Out of sync with market in terms of labour costs, fuel costs and generally in operating costs parameters

# SAA in perspective...

Coleman Andrews was brought in to stem the deterioration and turn SAA around onto a sustainable profitable growth path in 1998. Key focus of his strategy included:

- ▶ Focused cost reduction programmes
- ▶ Improved revenue management
- ▶ Sharply improved customer service
- ▶ Fleet upgrade and standardization
- ▶ Embedding a culture of business ethic
- ▶ Crafting and embedding a sound strategic vision

*We face the same problems today!!!..... Why?*



# The state of SAA today..

Organizational deterioration between 2002 and now has been allowed to reach the same levels that triggered the Coleman Andrews intervention:

- ▶ Lack of strategic vision and focus
- ▶ Lack of depth and experience in the airline industry
- ▶ Poor financial control and lack of consciousness for cost control
- ▶ Poor strategic choices
- ▶ Lack of accountability
- ▶ Beaucratic culture. The Triple P mind-set!!
- ▶ Out of sync with market in terms of labour costs, fuel costs and generally in operating costs parameters
  
- ▶ Consider the following few examples:
  - Load factors on routes like Accra on the massive 300-seater Airbus A340 or 330s are below 50%
  - On the CPT JNB schedule, the A340 with 317 passengers uses more than twice the fuel per passenger than a B737 with 170 pax. Profitability implications are clear
  - Foreign competitor airlines operate on lower cost per seat than SAA because of scale

Has the SAA been fit for purpose at every critical stage in the transition we have scanned?

# A glimpse into the state of Ethiopian Airlines (ET)..comparative analysis..

A comparison with Ethiopian Airlines is essential for a deeper appreciation of the decision making challenges confronting government.

1. Ethiopian Airlines has a geographical advantage that lends itself to an ideal “Hub and Spoke” route operating structure



## Morning Bank

Involves just over 52 flights to African destinations in the morning

## Evening Bank

They return and go out again on flights to the Middle East; Europe; Asia and the Americas same day

# State of ET cntnd...

2. The “Hub and Spoke” is supplemented by feeder hubs:

- ▶ Togo, West Africa (through its investment in Asky),
- ▶ Southern Africa (through Air Malawi) and
- ▶ One more planned for Central Africa

## State of ET cntnd ...

3. The government has consistently maintained commitment to its operational independence while demanding strict adherence to the lowest possible overhead costs. There is NO subsidy from the state. Therefore:

- ▶ Only professionally competent executive management with deep airline experience has been at the helm of the airline
- ▶ Current CEO Tewolde Gebremariam was the airline operations manager in New York for many years and succeeded Girma Wake who was with the Gulf Air prior to 2004.

# State of ET cntnd ...

## 4. ET have stuck to their business strategy that was crafted in 2004:

### ▶ Vision 2010

- which “repositioned the airline” driven by the objective of transforming turnover from \$400–million in 2005 to \$1–billion within five years. This was to be underpinned by the “revamped network” as indicated above
- By 2010, the airline’s turnover was \$1.3–billion, exceeding initial projections, as did passenger and cargo numbers

### ▶ Vision 2025

- Where the “new technology of aircraft” like the B787 and A350 demanded a longer-term horizon
- By that date the airline plans to have 120 aircraft flying to 90 destinations internationally and 20 within Ethiopia, turning over \$10–billion. The highly capital- and skilled labour-intensive nature of the business makes taking a long view imperative. For example it takes 10 years to train a B777 captain

# State of ET cntnd ...

5. The strategy is divided into five pillars:
  1. Maintain affordability and sustainability. Without this ET could not be able to attract funding from the capital markets for their substantial a/c acquisition strategy
  2. Strict maintenance of global standards at the lowest possible costs. ET's competitive advantage is cost.
  3. Competitive infrastructure.
    - a) Training academy capable of training 4000 students
    - b) Largest cargo terminal in Africa
    - c) The largest technical maintenance organization
    - d) Catering facility expanding to 80 000 meals a day.
  4. The integration of the airline's people, process and technology, including ICT, into a fully automated system "from cargo to payroll, finance to the manifests".
  5. Upgrading of technology to support point 4 above.

# The state of SAA today..

## My observations:

1. The Coleman Andrews intervention was a success, albeit a limited one, because the deep cuts in labour costs that were necessary to make SAA competitive were resisted by organized labour. However, the gains that were made have regressed substantially in the past fifteen years and the state is yet again confronted with the urgent need to intervene to settle debt obligations and inject capital in favour of SAA.
  2. We have deferred our responsibility and obligations to ask difficult questions in 2002 and in subsequent years on the question of purpose for SAA?
  3. We have failed to ensure that the Boards since 2002 consisted of individuals with extensive and deep business experience and air transport competence and that it was given the oversight latitude without political interference.
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# The state of SAA today

1. More critically, we have failed to ensure that management with both business and air transport experience is appointed to run the airline on strictly commercial basis.
  2. We are now faced with the same challenges that made it necessary to bring in Coleman Andrews. SAA was technically insolvent then as it is now. However what we have now is catastrophic in proportion.
  3. The level of accumulated losses and the capital injection required raises very serious questions about the level of the opportunity cost that, given our economic situation and the increasing social challenges and obligations that confront us, has become morally impossible to defend and justify.
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# Conclusion and Recommendations

There are no simple answers to questions 2,3, and 4 in your brief. Whatever option is ultimately chosen, the State must undertake an urgent rational evaluation of the “Public Interest” factor and finally make a decision on purpose and ownership.....

I have noted that the Min of Finance has stated the need for integrating the SAA operating assets. This unfortunately goes counter to conventional wisdom that separates low cost “point to point” operations from “long haul” operations. Success drivers in the former business model focus on low costs; in the latter on revenue optimization on the long routes. The correct statement would be to say “optimize operating assets”. Operating structures are therefore different..... It is immensely difficult for an airline to be both.

The real and fundamental question as discussed earlier is: What must be done to make SAA “Fit for Purpose”?

I see the following options for SAA:

1. Put SAA into business rescue and restructure aggressively. This provides a legally unchallengeable environment to do what is necessary. Under this option, all legacy agreements (including employment) are up for revision within the limited affordability.

# Conclusion and Recommendations...cntd

2. Pursue an aggressive drive for efficiency optimization at all levels while concurrently developing detailed answers to the question: What exactly must be done to make SAA "Fit for Purpose"?

- a) Define clear purpose and market place for the low cost and long haul operations
- b) Define appropriate business models and organizational strategies and structures
- c) Aircraft fleet plan and human resources strategy
- d) Develop a funding framework and plan
- e) Draw a comprehensive and detailed execution plan and clear intended outcomes
- f) All of the above must be completed within ten (10) weeks
- g) Then decide on the level and type of capital injection required.

It is critical that this process is executed under very tight independent supervision and oversight for success and in order to protect the public interest because we have been here before.

