

# Separation or integration? Can network carriers create distinct business streams on one integrated production platform?

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## Abstract

The worldwide airline industry is currently facing one of the most severe crises in its history. Particularly affected are the network carriers, which need to develop more distinct products to adapt to the changed market environment. Since structure needs to fit strategy, the question of how the network carriers need to design their organization arises. So far carriers have either used one flight operation (production platform) as a basis for all products offered, or have built separate organizational entities for each business segment. From a corporate strategy point of view this paper compares the efficiency and effectiveness of an integrator versus a separator approach. The analysis indicates that the integrator approach is both less efficient and effective and it is argued that the network carriers should preferably operate with separate entities.

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## 1. Situation in the airline industry

External shocks, such as terrorist attacks, wars in Afghanistan and Iraq, the SARS epidemic and the worldwide economic downturn have hit the aviation industry badly. Many airlines have posted substantial losses, and according to the chairman of Lufthansa's supervisory board, Jürgen Weber, about half of the airlines are de facto bankrupt (Weber, 2003). Thus, most experts agree that the current slump is not a typical downturn and that the external shocks have uncovered much deeper problems in the industry.

The presently dominant network carriers are particularly affected, whereas most low-cost carriers are operating with high profitability. The originally innovative and successful hub-and-spoke system has transformed into a highly complex structure that causes low productivity without delivering adequate value, neither to the vital business customers nor to the different kind of leisure customers. Furthermore, the network carriers' most important customer group, business/frequent flyers, have changed their flying behavior. To reduce

travel costs, large companies have negotiated volume discounts and changed travel policies partly restricting business class bookings. Besides, travel substitutes such as video conferencing have gained attractiveness due to security concerns after 9/11. To add to this all, new competitors have entered the market with a completely different business model. The so-called low-cost carriers have successfully designed a focused operation providing them with a significant cost advantage. Experts estimate that they operate with up to 60% lower unit costs than network carriers (Hansson et al., 2003). The fact that most of them were profitable during the crisis, underlines the sustainability of the new business model (Cordle, 2002). These circumstances have led to a downward trend in travel volume and yield.

As a counter measure, network carriers started typical restructuring activities, such as cutting variable cost by grounding aircraft or reducing fixed costs by laying off staff. These measures are definitely necessary, but at the same time insufficient. This paper argues that network carriers need to go one step further and overhaul their business models to cope with the changed environment.

Together with their alliance partners, the major airlines have established worldwide nets consisting of linked hub-and-spoke networks. This has enabled them to offer a wide range of products to all kinds of

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customer needs (e.g. business or leisure customers; continental or intercontinental routes) and at the same time allows them to bundle the traffic flows and thereby increase cost efficiency.

Full service carriers have continually introduced new product features and services to stay ahead of the competition because they operate in a market with a high technical homogeneity of input factors (e.g. aircraft, staff, airports). However, due to the low imitation barriers, any competitive advantage based on product differentiation is most likely to erode in a short time. Today the vital business customers receive an indistinct product that does not satisfy their expectations with regard to travel-time, convenience and price. At the same time, full-service carriers deliver an over-engineered product to leisure customers who are more price and less time, service and convenience sensitive. By trying to cater to everybody, network carriers have ended up with a product that is neither able to satisfy the business customers quality and service demand, nor the price expectation of the leisure customers.

Furthermore the continuous broadening of the scope of operation, service for all possible customer types and wishes through the same organization (production platform) has raised the complexity cost of the operation significantly. In the end, the strategy for maximization of product range and minimization of costs simultaneously seems to lead to a dead end. Nowadays network carriers are neither leaders in costs nor distinguish themselves in product quality—in Porter's words: they are stuck in the middle (Porter, 1980).

## 2. Emergence of four distinct airline products

In other industries, such as telecommunications, finance and manufacturing, incumbents that faced similar situations in the past separated their organization into distinct business streams. Traditionally these divisions are lined up according to the operational requirements. Airlines distinguish between the flight distance (continental and intercontinental) or traffic type (point-to-point or and hub-and-spoke). In addition, customer groups should be considered, which can be classified by various criteria, such as purpose of travel (e.g. business, leisure, vacation), price and time sensitivity (e.g. budget or VIP travelers), service orientation, and so on. The separation of charter airlines flying only tourists to their holiday destinations is one example for the separation of one business unit to target one specific customer group.

In Fig. 1, the different traffic and customer types are combined within a matrix. On the vertical axis the type of traffic is distinguished by the distance. The horizontal axis distinguishes between customer value ranging from low value customers (e.g. budget travelers) to high value

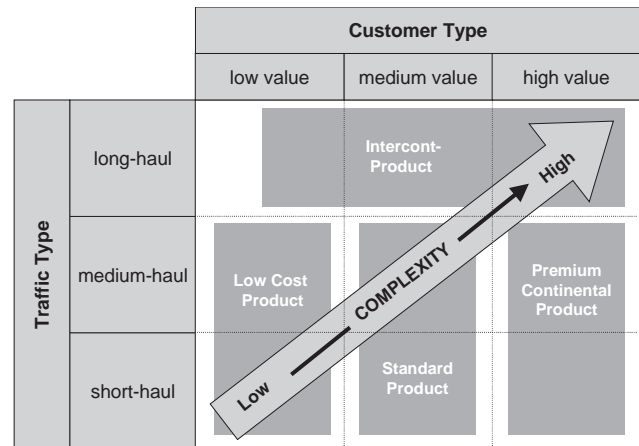


Fig. 1. Segmentation of airline products.

customers (e.g. business/frequent flyers). Parallel to the increase of customer value, the demands of these customers diversify. In the case of the budget travelers, for instance, the price is the factor that matters in particular. In contrast, business travelers are characterized by different demands depending on the flight distance,<sup>1</sup> for example. Furthermore, the diagonal arrow displays the growth of complexity. The least complex business is to fly low value customers point-to-point on the continent and the most complex business is to fly premium customers via a hub-and-spoke network across the oceans. Accordingly, the complexity grows parallel to the increase in flight distance and targeted customer value. As shown in the graph, the airline business can be split into four different products, which could be briefly circumscribed as follows:

- *Intercont-Product*: Carriers and their partners focus on intercontinental travel offering a three class product with differentiated services on the ground and in the air (e.g. for first class customers: special lounges, highest convenience and comfort, priority baggage handling, specially trained staff, in-flight entertainment). The network of global alliances secures worldwide coverage. The local alliance partners handle connecting flights. Most flights are routed through the major international hubs. Non-local traffic is fed by the other business streams.
- *Premium-continental-product*: Offering frequent point-to-point (P2P) services to all major cities on the continent. Product features focused on the needs of the time sensitive business/frequent flyers. Less focus on onboard frills, such as entertainment or top quality food, however special focus on fast and convenient pre- and after-flight services on the

<sup>1</sup>With the increase in flight-time, the on-flight-service gains importance, while on short flights the convenience and rapidness of the pre- and after-flight services are more important (see Sterzenbach, 1999).

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