Strategic Group Performance in the Commercial Airline Industry

Strategic Response to Structural Disequilibrium

Sam D. Cappel, Terry R. Pearson and Eric J. Romero

Abstract

Research based on Porter's typology of strategic groups (Cappel, Tucci & Wyld, 1996) indicated that the most successful U.S. based airlines at that time belonged to the strategic group that employed a strategy combining elements of low-cost and differentiation. Later, as deregulation of the industry was introduced in Europe, the authors found that superior financial performance was achieved by European airlines that employed a singular low-cost approach. After the events of September 11, 2001 it appears that the most successful U.S airlines in terms of financial performance are those adopting a low-cost approach. The theoretical question to be examined is whether recent events creating disequilibrium within the industry have resulted in temporary or permanent changes in the relationship between financial performance and generic strategy choice.

Key words: Airlines Strategy

Through 1979, the government regulated prices charged by commercial airlines operating in the United States. Price regulation diverted carrier rivalry into cost increasing service competition. Immediately following deregulation, competition among major airlines shifted from differentiation strategies to cost leadership strategies. For the past twenty-two years, competitive practices within this industry have been characterized by "price wars," interrupted briefly by short periods of price stability. A study conducted by Cappel et al. (1996), based on Porter's (1980) generic strategy framework, theoretically evaluated three propositions to extend existing strategy research to the airline industry. Unique forces affecting the relationship between strategy and performance within the airline industry were examined within this study. Based on the industry environment at that time, the authors found that both in terms of financial performance and operating performance, airlines employing a combination strategy based on both cost leadership and differentiation were attaining a competitive advantage relative to airlines adopting a singular approach. The current research examines the industry structure post deregulation in the EC and the 9-11 tragedy, in an effort to determine whether the current relationship between the selection of a low-cost strategy and superior financial performance will continue.

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Generally, competitive positioning commonly involves a singular approach emphasizing a cost leadership or differentiation strategy. However, some competitors may adopt an approach which combines cost leadership and differentiation. This study examines the potential for competitive

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advantages offered by each of these three approaches.

Elements of Generic Airline Strategies

Cost Leadership

Cost leadership is the approach used by a business that seeks to be the low cost producer in an industry. This strategy involves the provision of no-frills outputs industry-wide and is associated with cost controls and economies of scale resulting in the ability to accept lower prices, if necessary, and remain profitable. Therefore, the cost leadership strategy is commonly referred to as the low cost approach. Low cost focused strategies that take advantage of cost advantages based on purchasing practices, hedging, technological advances, efficient staffing, efficient use of terminal space and routing structures. These firms can also take advantage of load factors, thus providing very efficient service as would be expected of low cost competitors.

This approach is associated with carriers such as, Reno Air, Air Tran, and Southwest Airlines in the United States market. As airline deregulation has spread to the European Union, we find this strategy to be supported by Ryanair Holdings PLC of Dublin Ireland, which was honored for having the best financial performance among national airlines in 1999 (Lowry, 1999). Ryanair's successful business plan emulated the business strategy employed by Southwest Airlines It offers low fares and short-haul service on highly trafficked air routes in Europe which has stimulated growth (Lowry, 1999). Low cost airlines are revolutionizing air travel in Europe where large airlines once were the only viable operators (Sparaco, 2002). Ryanair and EasyJet are two examples of airlines that are expanding aggressively into markets previously dominated by the major European airlines.

Differentiation

Differentiation is the approach used by a business that sees itself as unique regarding certain characteristics valued by consumers in its market. Such a business may be able to command above average prices for its outputs. Airlines with a differentiation strategy engage in marketing efforts focused on promoting an image of exclusivity based on service quality, reliability, and safety to a broad range of consumers or a narrow segment of the market.

This strategy is associated with carriers such as British Airways and Japanese Airlines (JAL). The approach rests on differentiation tailored to characteristics of customers representing the carrier's various target market segments. Amenities such as leather recliners with built in massage systems, gourmet meals, and extensive wine lists may be offered by these carriers. Singapore Airlines is well known for it competitive advantage based on superior service. (Ramaswamy, 2002).

Combination Strategies

Combining low cost and differentiation strategies is the approach adopted when a carrier seeks to simultaneously pursue a low cost strategy while attempting to achieve. Such a strategy has been employed by most major airlines operating in the United States such as American, Continental, Delta and United. These airlines maintain low costs through staffing, technology and high load factors, which result in reduced overhead. Simultaneously, they use image marketing, market segmentation and superior service which command premium prices for certain select services and customer groups. Comair Holdings Incorporated, scored highest among the regional carriers for 1999 in terms of financial performance, and is considered one of the "best managed" and "most innovative" regional airlines. It has a strategy based on combining quality service and low cost in serving market niches defined by population density (Lowry, 1999).

Propositions

Three propositions are suggested in this study of competitive approaches within the airline industry.

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Low Cost Advantage

The results of several prior industrial studies indicating that although business level economies of scale can sometimes be reached at low operating volumes, larger businesses tend to achieve a competitive advantage based on reduced cost structures attributable to firm level economies of scale in purchasing, finance, and marketing (Hill, 1988; Miller & Friesen, 1986a; Wright, 1987). Based on this line of reasoning, it is theorized that successful large firms in the airline industry will principally compete based on low cost. They would be expected to do so in an attempt to bid customers away from competitors and to capitalize on advantages associated with business level economies.

According to past findings, businesses that primarily compete with the low cost approach tend to achieve high market shares through the offering of low prices, made possible by economies of scale (Carroll, Lewis & Thomas, 1992; Hambrick, 1983a, 1983b; Henderson, 1979; Porter, 1980, 1985). However in many service industries, advantages associated with economies of scale are limited (Allen, 1988; Cool & Dierickx, 1993; Thomas 1978).

Though business-level operating economies can be reached at low volumes in some service industries, larger businesses within these industries may still have cost advantages since they may potentially benefit from economies in finance and marketing (Hill, 1988; Miller & Friesen, 1986a, 1986b; Wright, 1987). Alternatively, Wright, Hotard, Kroll & Tanner (1990) contended that business units competing primarily with the low cost strategy may perform well because their lower cost positions allow them the opportunity to attract customers from other businesses through the offering of lower prices. The first proposition can thus be stated as:

P1. Those airlines that primarily compete based on low cost will perform better than those simultaneously competing with low cost and differentiation.

Several unique factors come into play in limiting the effectiveness of low cost strategies among airlines. Successful implementation of the low cost strategy by airlines may require more than addressing the needs of the price sensitive consumer. The very public nature of the airline industry also limits opportunities for proprietary strategic and technological advantages. This is because there is much emulation regarding the adoption of technology and strategy in service industries (Hawes & Crittendon, 1984; Wortzel, 1987).

In outlining the prerequisites for successful implementation of a low cost strategy Murray (1988) states: “A cost leadership strategy is viable only if cost structures vary across competitors within an industry in ways other than in direct ratio to output” (p.392). Commercial airlines reportedly have less variability in cost structures across competitors than industrial businesses because of limited size advantages, the public nature of the industry, and consumers’ perceptions regarding price. Thomas (1978) reported that the benefits of size available to people-based service businesses, such as airlines, are principally limited to advertising- expenses.

In addition, low pricing may not create the same advantages for commercial airlines as it does in an industrial setting. In service businesses, an image of poor quality may result from the adoption of a low price position (Thomas, 1978). Limited size advantages, the public nature of the industry, and consumers’ perceptions regarding price may be among the factors that could underlie the weakness of a single-minded low cost approach.

Differentiation Advantage

The literature suggests that businesses primarily competing with a differentiation strategy may outperform those competing on a low cost basis (Wright, Hotard, Kroll & Tanner, 1990). Enterprises that primarily compete with a differentiation strategy may obtain a competitive advantage, in spite of higher cost positions, since unique product or service offerings allow the

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alternative of charging higher prices (Wright et al., 1990). Berry, Parasuraman, & Zeithaml (1988) recommend a strategy of differentiation based on service quality for service organizations. Berry, Parasuraman & Zeithaml (1988) state, "service quality has become … the most powerful competitive weapon most service organizations possess" (p.35). The paradox to service excellence, however, is that commercial airlines that are not cost competitive are increasingly vulnerable since differentiation possibilities tend to diminish over time.

The commercial airline industry has been characterized by Borenstein (1992) as a mature industry. Kotha and Vadlamani (1995) findings suggest that businesses competing in mature industry environments are not necessarily helped by adopting a low cost strategy. Rather, using differentiation appears to be a more effective means for achieving competitive advantage in mature industry environments. The second proposition can thus be stated as:

P2. Those airlines that primarily compete based on differentiation will perform better than those competing with a multiple approach combining low cost and differentiation.

Van Scyoc (1989) characterizes the commercial airline industry as being in the maturity phase of the life cycle, stating that inflation adjusted growth in the industry is relatively stable. Porter (1985) maintains that, as an industry matures, competitors' product and service offerings gravitate toward the product and service configurations most preferred by customers, reducing opportunities for differentiation. This theoretical position is examined by Lawrence & Hume (1992), who report that the amenities and discount pricing practices of commercial airlines are becoming more similar. It can be argued that air travel is becoming more of a commodity due in part to expanded access to information. Value shoppers can now compare prices, connections, and book flights on the Internet. This surge in information availability diminishes the benefits traditionally associated with travel agent commission override programs, proprietary computer reservation systems, and code sharing. Improvements in frequent flier programs are immediately adopted by competing carriers. Many carriers are upgrading services to include such amenities as roomier seats and legroom, better in-flight entertainment, and higher quality meals. As a result, historic opportunities for differentiation are diminishing within the commercial airline industry.

One difficulty experienced by airlines attempting to successfully implement a business strategy principally based upon differentiation is that of determining what is of value to the consumer. There is little consensus among consumers of services as to what constitutes value (Dodds, Monroe & Grewal, 1991). The value or quality of products and services is determined by the individual consumer and does not readily lend itself to generalization (DeSousa, 1989). Therefore, if individual customers do not value products and services that differ along non-price dimensions, they will not value a differentiated product or service and will not pay more for the product or service.

Combination Advantage

Competing on the combined approach of differentiation and low cost may be beneficial, because the differentiated output (products and services) has the advantage of higher pricing, while emphasis on low costs maintains costs in comparison to rivals. Past research indicates that competing with a combination of these approaches has often been associated with higher profitability and larger market shares (Buzzell & Gale, 1987; Buzzell & Wiersema, 1981; Hall, 1983; Jones & Butler, 1988; Miller & Friesen, 1986a, 1986b; Phillips, Chang & Buzzell, 1983; White, 1986; Wright et al., 1990). Thus, the third proposition can be stated as:

P3. Those airlines simultaneously competing on the combined basis of low cost and differentiation will perform better than those airlines primarily competing solely on low cost or differentiation.

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The emergence of the "smart shopper" may be one of the reasons airlines employing a combination strategy would outperform airlines that principally adopted either the low cost strategy or the differentiation strategy. Fulmer and Goodwin (1988) state that given a hypothetical situation in which there are firms; A, B, and C respectively, and firms A & B offer the same services and products but B has lower costs, firm B will win. If firm C chooses to differentiate, success will depend on customers' willingness to pay a higher price for C's products or services to increase satisfaction. Firm C will only be successful if this additional value justifies the cost differential in the mind of the customer.

This same line of reasoning is extended by Watkin (1986) who states: "Competitive advantage occurs when a firm positively affects its buyers' value chains, either by lowering buyers' costs or improving buyers' performance, or both" (p.11). Theoretically, airlines using a combination strategy may pursue cost advantages based on inventory methods, purchasing practices, technological advances, efficient staffing, and efficient use of terminal space while also taking advantage of high load factors, thus providing very efficient service. In addition, the broad product line offerings that are characteristic of these firms may at the same time allow marketing-based differentiation. It is reasonable to expect that marketing efforts focused on promoting an image of business exclusivity, safety, reliability, and service quality may be generalized to a broad range of customers. This may permit commercial airlines successfully to pursue a strategy of marketing-oriented differentiation and one of cost leadership. In this situation both advertising, which builds customer loyalty and a differentiated image, and operational efficiency, can benefit from advantages of size.

Further, Ott (2000) demonstrates that the business strategies of JetBlue Airways and National Airlines are successfully serving market niches in the United States commercial aviation market by taking advantage of the consuming public's disenchantment with traditional niche market airlines that employ low cost strategies. These relatively new airlines with their alternative strategies of niche low costs / differentiation, employ a higher level of service throughout their operations, particularly in the areas of cabin service, new aircraft, reliable schedules; and a well-paid professional work-force. The utilization of fuel efficient mid to small capacity jets to address demand on high traffic regional routes that connect with services offered by the major airlines, is being integrated into the strategies of many commercial airlines (Moorman, 1999). These alliances, combined with an entrepreneurial approach to business strategy and execution seem to be factors of the competitive mix needed to be successful in the commercial aviation market of today (Lowry, 1999; Ott, 2000; Flint, 1999).

Discussion and Conclusion

If indeed, major airlines in the United States commercial aviation market simultaneously competing with the low cost strategy and the differentiation strategy financially outperform those airlines primarily competing with either strategy alone, then proposition three negates the first two propositions. However, if either proposition one or two proves correct, then proposition three could not be accepted.

One question to be answered within the context of this paper is whether the propositions set forth are mutually exclusive. Reports of financial performance for the year ending December 31, 1999 indicate that Delta had the best financial performance among global carriers, Ryanair had the best financial performance among national airlines, and Comair ranked highest in financial performance among regional carriers. Both Comair and Delta employ combination strategies based on low cost/differentiation, however Ryanair employs a low-cost strategy. However, more recently as the industry rebounds from terrorism and recession many carriers are concerned about their economic health (Zellner & Arndt, 2002). With increasing costs (labor and fuel), the shrinking and thriftier business traveler, and identity-based pricing one

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must ask if the major hub-and-spoke carriers core business model is valid in today's marketplace (Zellner & Arndt, 2002)? The airline industry lost billions of dollars in 2001 and 2002, and may not show a return to profitability (Velocci, 2002). Others claim that the industry will not return to profitability until 2003 or 2004, while many believe the industry was in trouble before September 11th due to poor management, high costs, weak demand for business travel, labor issues, and a patchwork route system.

While these results bring to question the proposition that airlines employing a combination strategy will outperform those employing singular strategies, another issue arises. Is this a change in the industry or simply an anomaly? Only with time can the answer to this question be addressed. The European Union has just recently deregulated the airline industry, therefore, after the airline industry in Europe fully adapts to a deregulated environment will it be possible to answer this question? As deregulation of the airline industry is increasingly adopted on a global scale, as well as recovery from terrorism and recession, we may expect that airlines employing single or multiple strategies may for a short time achieve superior financial performance as the process of evolution to a more global industry transpires. The only commonalities discovered among the aviation companies that scored first in terms of financial performance in 1999 were: prudent yet aggressive management strategies, a customer driven focus, and management teams that took aggressive entrepreneurial approaches to business strategy and execution (Lowry, 1999).

Since 1999 we find the year 2002 composed of weak demand and thriftier business travelers, therefore the expanding point-to-point low-cost and point-to-point low-cost / differentiation players, such as Southwest and JetBlue are the only companies in today's economy bucking the trend of net losses with profits and increasing load factors (Zellner & Arndt, 2002; Stross, 2002; Sutton, 2002). However, as of January 2002 American, United and Delta were ranked as the top three airlines, but all posted net losses (ATW Research, 2002). Furthermore, Green (2002) rated American Airlines best North American carrier and Singapore Airlines best global carrier. As one can summarize rankings do not always mean profitability. With the losses these companies are experiencing and may continue to experience one might also inquire if the core business model of these airlines is broken, if so then all characteristics of the product and cost structure must be further examined (Zellner & Arndt, 2002).

The purpose of this paper is to provide a research agenda for extending the analysis of Porter's generic strategies within the airline industry which is becoming more de-regulated, market oriented and global in nature. While Porter's generic strategies may be applicable to successful business strategy in the industrial sector, their applicability in the commercial airline industry may also be theoretically questioned. It is the opinion of the authors that extensions of this research over time will help to clarify strategy-performance relationships within service industries which are adapting to a more globalized business environment. The results of such research, regardless of outcomes, may clarify these relationships for the benefit of academicians and practitioners alike.

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