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Strategic alliances in the airline industry: The Star Alliance

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1.0 Introduction

Due to a number of underlying forces in the current global business environment international strategic alliances are a fast growing cross border organisational form. Large trading blocs, lower tariff levels, and short transmission times of technology and information are describing today's economic world. In more and more industries markets become global combined with the development of global technologies. To cope with this changing environment there is an increasing demand for investment resources. (Faulkner 1994) In this context companies are realising that to remain competitive and to gain competitive advantage co-operation with actual or future competitors offers great advantages (Porter Lynch 1998).

It is not surprising that also in the airline industry the number of strategic alliances increased in the last years (Clarke, Douglas and Hermens 1999). But it was only in the past few years that big strategic alliances are emerged. The Star Alliance made the start in 1997 (Taverna 1997) and was soon joint by one-world and Wings Alliance.

This report examines some of the key issues concerning the Star Alliance. It is focusing on the reasons why the alliance was formed, what its objectives and strategies are. Finally it evaluates if the alliance is paying off for its members.

To achieve this the first step will be to define strategic alliances and what types of alliances are possible. The next step will be an overview of the airline industry itself followed by the examination of the Star Alliance.

2.0 Strategic Alliances

To get a better understanding of the Star Alliance it is necessary to have a general look on strategic alliances. The definition is one point but also the different types of strategic alliances. Another important question is why companies are forming strategic alliances. These issues are discussed in this paragraph.

2.1 Definition of strategic alliances

David Lei offers the following definition of a strategic alliance:

> Coalignments between two or more firms in which the partners hope to learn and acquire from each other technologies, products, skills and knowledge that are not available to other competitors (Pelton, Strutton and Lumpkin 1997, p. 485).

In this context the term coalignment implies that one company links its organisation with other companies to achieve a common objective (Pelton et al. 1997) whilst each company retains its corporate identity (Faulkner 1994). The timeline for achieving the common objective may vary but it is often a long-term linkage (Pelton et al. 1997). The common objective is very important it is the basis of the alliance. Considering this objective decisions and choices are made in the alliance (Pelton et al. 1997). Alliances are often built between companies with different core competencies. These different core competencies and the resources of the members are pooled to exploits market opportunities (Pelton et al. 1997). Thus most alliances involve an exchange of technologies, products, skills and knowledge among the partners (Pelton et al. 1997). In fact learning from the partner and trying to apply the gained knowledge in the own organisation is one of the major benefits of being in an alliance (Hill 1997). But an alliance is not just trading competencies it is about realising synergies between the companies and building of a durable competitive advantage for the partners, that each could not realise alone (Faulkner 1994).

2.2 Classification of Alliances

There are many different types of alliances and according to Faulkner there are many different ways they are classified in the literature (Faulkner 1994). To get clear categories of strategic alliances nature, structure and membership can be used as classification (Faulkner 1994). The nature of an alliance can be focused or complex. A focused alliance has specific objectives and may only involve one value chain activity from each partner. Whereas a complex alliance may involve complete value chains and the objectives are widely spread. The two possible structures of alliances are joint ventures or collaborations. A joint venture has a separate legal existence whereas a collaboration has not. Only two partners can form an alliance or it can be a consortium if more than two partners are involved. This classification gives eight possible types of alliances as shown in Figure 1. (Faulkner 1994) Accordingly an alliance may be a complex consortium collaboration, or a focused two-partner joint venture, and so forth.

An analysis of 228 alliances showed that the majority of alliances are two-partner joint ventures (45%). In this sample consortium ventures and two-partner collaborations are accounting for 22.5% each. (Faulkner 1994) The current picture might have changed but during the research no newer figures could be found.

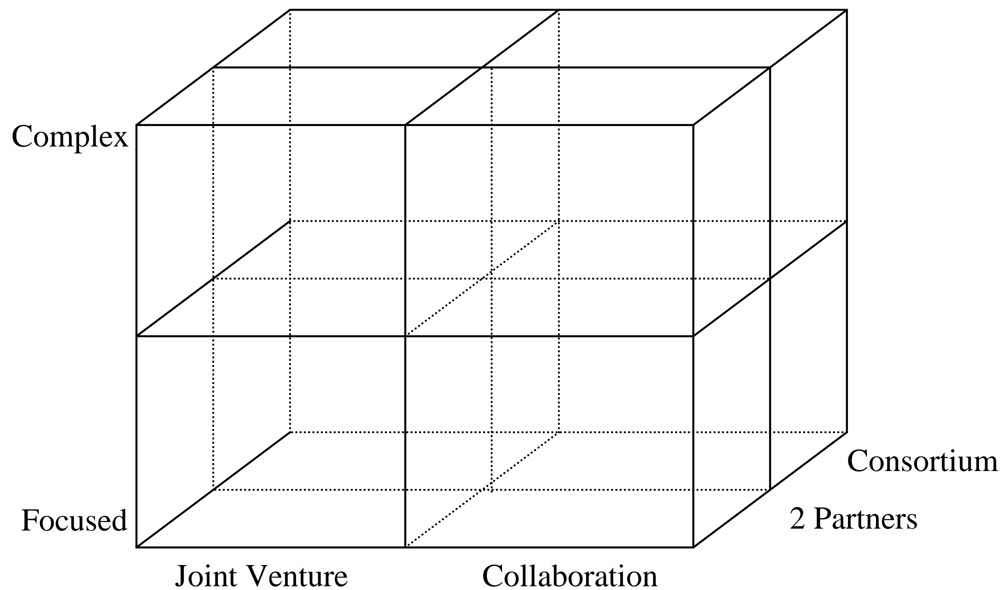

Figure 1: The strategic alliance options

Source: Faulkner 1994, p. 133

2.3 Reasons for strategic alliance formation

Faulkner (1994) suggests that the strongest force leading to the popularity of strategic alliances is the globalisation of markets. This is a more general view and it does not explain specific reasons why companies are forming alliances.

In the competitive global market place companies are forming alliances to reach market and profitability objectives they could not attain alone (Pelton et al. 1997).

When companies are attempting to facilitate entry into a foreign market they sometimes lack the resources, expertise, or experience needed to be successful in the market. A partner in the foreign country can help to overcome such limitations. Thus strategic alliances are formed to open new markets. (Hill 1997; Pelton et al. 1997)

Strategic alliances can be used to gain economies of scale in procurement and allocation of resources. The partners can pool limited resources in order to reduce wasteful, redundant activities. (Pelton et al. 1997)

In today's fast changing environment strategic alliances can help to reduce risks involved in market and product development (Hill 1997; Pelton et al. 1997). At the same time the time-to-market of new products can be reduced and partnerships also can yield technological advantages (Pelton et al. 1997). To gain market share in order

to attain necessary economies of scale is another reason for forming strategic alliances (Pelton et al. 1997). This is especially important because of the rising costs of development. It can also make sense to form an alliance to establish technological standards for example Philips and Matsushita allied to develop and market the digital compact cassette (DCC) system (Hill 1997).

If a company wants to expand into related or unrelated industries a strategic alliance frequently enables a company with little experience in this industry to move quickly up the learning curve and capitalise on opportunities (Pelton et al. 1997).

One major rationale for strategic alliances is by combining the partners' complementary strengths the opportunity to create exchange value and gain positioning advantage that neither company could have developed alone (Hill 1997; Pelton et al. 1997). Although this may not lead to an equal payoff a win-win situation must be possible for each partner (Pelton et al. 1997).

3.0 The Airline Industry

The airline industry is a global business. But it is also characterised by geographic advantage of some companies. Local companies have in their region most of the landing slots and are most of the time favored by the local government. The airline industry is depending on government treaties and agreements like flexible bilateral agreements to get access to traffic rights. (Clarke et al. 1999) The existing bilateral air services agreements require substantial ownership and control by state's nationals. The result is that airlines owned by another state's national cannot benefit from the granted traffic rights. These outdated restrictions are making mergers impossible and lead to the development of alliances (Relf 1999). With open sky agreements governments are trying to deregulate and open up markets. But some governments encourage at the same time the development of the so-called mega-alliances and actual competition is eliminated (Shifrin 1997). Another problem can be seen in the infrastructure. There is only a limited number of landing slots available and therefore it is not easy to get slots. (Clarke et al. 1999)

The performance of the airline industry was good in the last year. But only members of the big alliances were able to generate profit (US$ 11.7 billion). The industry generated a US$9 billion profit therefore there was an aggregated loss of US$2.7 billion. (Clarke et al 1999) But the airline industry is cyclical industry. Therefore the

performance of the members of the big alliances over a cycle has to be observed (Upbin 1997). On the other hand the leisure market grows faster than the more rewarding business class market whilst the return for economy class seats decline 2% per year (Clarke et al. 1999). For example in the European market the low-fare market is the fastest growing. It will probably double by 2002. Due to low-fare airlines, which are using smaller airports, regional destinations and secondary airports of capital cities, the competition in this market segment is fierce (Clarke et al. 1999).

The customers of airlines can be classified into two types. The first type of customers includes the global businesspersons and 'road warriors'. These customers are searching for a seamless travel experience. Additionally they want to have a worldwide network and service reach (Clarke et al. 1999). These customers are mostly full paying last minute customers and therefore especially valuable for the airlines (Upbin 1997). Leisure and occasional traveller is the second type of customers. They have market specific desires. This group has a strong price focus (Clarke et al. 1999). Due to the decline of returns for these seats this passenger group is not that valuable for the airlines.

The competition in the airline industry is changing. The competitors are no longer single airlines. In today's environment large alliances are competing with each other. Each alliance is accounting for more than 15% of the world market. Although the competition has spread to worldwide relationships it is still intense at the local level as shown in the example of the smaller carriers in the European market. Airlines that are not members of an alliance are still strong in specific international markets like for example within the European Union and also on domestic routes. (Clarke et al. 1999)

Traditionally airlines had difficulties extracting their share of value. Airports, aircraft manufacturer, and distribution systems have eroded the airlines' share (Clarke et al. 1999). In this context especially labor is a big problem. Strike threats and strikes make sure that the staff gets its share (Upbin 1997). It is doubtful if the alliances can change this but the alliances gain leverage when purchasing insurance, fuel, accommodation, etc. (Clarke et al. 1999).

The industry has relatively low barriers to entry. A lot of things can be outsourced. For instance an aircraft with a complete crew can be leased from specialised companies. Landing slots can be bought from airlines that currently do not need them or they are still available at regional or secondary airports. New entrants often compete on price (have a low cost strategy). The survival rate of the new entrants is

quite low. In most cases they are driven out of the market when a bigger player starts to compete on the same route. If they are successful they are often acquired by on of the bigger airlines. (Clarke et al. 1999)

In some areas the airline industry has to compete with substitutes. The London Paris market lost share to the channel tunnel. In the domestic markets in Europe airlines have to compete more and more with high-speed trains. This must not be necessarily on price. (Clarke et al. 1999) For example trains can bring the customer directly into the city center whereas most airports are outside or on the outskirts of cities.

4.0 Star Alliance

In May 1997 "executives of five major airlines, led by Lufthansa and United, signed

> … what they termed a "letter of intent" to consolidate and strengthen existing bilateral cooperation under a visionary – yet to be fully defined – "openended" sales and marketing umbrella called Star Alliance." (*Air Transport World* June 1997, p10)

Air Canada, Scandinavian Airline System and Thai Airways International were the other members of the new partnership (Taverna 1997). Varig joined just a few months later (*Air Transport World* June 1997, p10). Star Alliance was the largest, most comprehensive and first truly global alliance in the airline industry (Taverna 1997). The number of members increased and in October 1999 there are nine members. All Nippon Airways, Ansett Australia Holdings Limited and Air New Zealand joined the alliance and Austrian Airlines, Singapore Airlines and Mexicana Airlines will join in 2000 (Star Alliance 1999).

The Star Alliance can be classified as a complex consortium collaboration as it is shown in Figure 2. It was founded as a marketing alliance to offer seamless travel and help with cost cutting (Taverna 1997). Later it also involved technical support (Taverna 1998) and in some areas cargo transport (Bowman 1998). So the objectives are widely spread and involve more than one part of the value chain. With now nine members and three new members joining next year (Star Alliance 1999) Star Alliance surely is a consortium. Although it has its own management board (*Aviation Week & Space Technology* Dec. 14 1998, p47) Star Alliance has no separate legal existence and is therefore a collaboration and not a joint venture (Taverna 1997).

One reason behind the formation of the alliance was to get access to global markets with less investment in planes, gates, etc. (Beirne 1999b). Neither airline was able to

set up a truly global approach on its own (*Airfinance Journal* Jun 1997, p22). Another reason was the need for reducing costs (Taverna 1997).

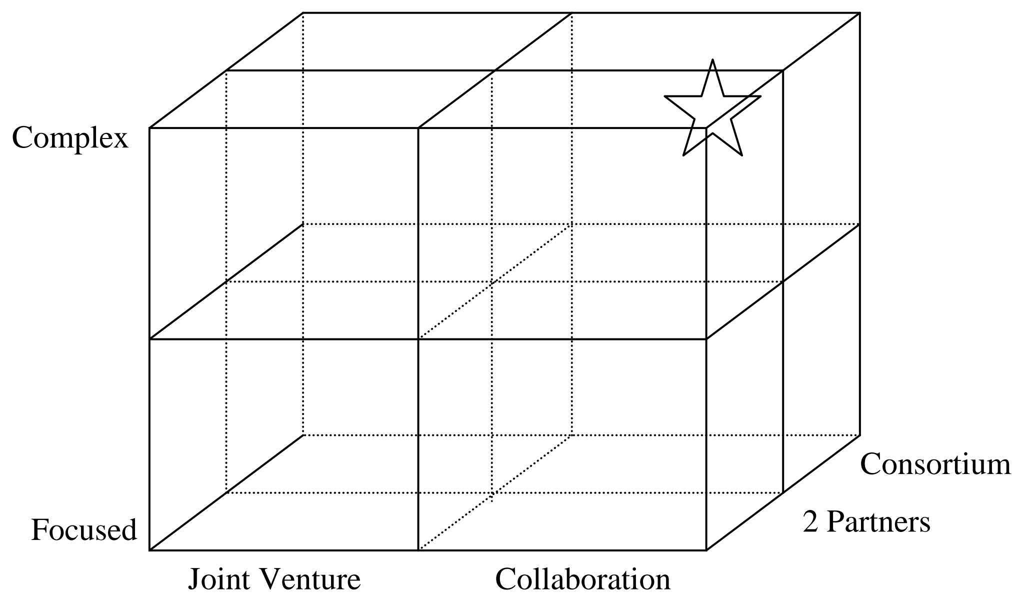

Figure 2: Classification of the Star Alliance

Source: Faulkner 1994, p. 133

4.1 The members

As mentioned before the Star Alliance has currently nine members. Following a brief overview of the airlines and the alliance is given.

United Airlines

- Fleet 592 aircraft
- Number of destinations 259
- Countries served 27
- Passengers per year 87 million
- Number of employees 98,810

Lufthansa

- Fleet 327 aircraft
- Number of destinations 301
- Countries served 89
- Passengers per year 40.4 million
- Number of employees 54,867

All Nippon Airways

- Fleet 144 aircraft
- Number of destinations 65
- Countries served 14
- Passengers per year 41.8 million
- Number of employees 15,273

SAS

- Fleet 185 aircraft
- Number of destinations 101
- Countries served 35
- Passengers per year 21.7 million
- Number of employees 24,000

Air Canada

- Fleet 244 aircraft
- Number of destinations 120
- Countries served 26
- Passengers per year 18.8 million
- Number of employees 23,000

VARIG

- Fleet 87 aircraft
- Number of destinations 120
- Countries served 20
- Passengers per year 11 million
- Number of employees 17,740

THAI

- Fleet 77 aircraft
- Number of destinations 73
- Countries served 35
- Passengers per year 15.2 million
- Number of employees 24,222

Ansett Australia Holdings Limited

- Fleet 126 aircraft
- Number of destinations 142
- Countries served 5
- Passengers per year 13.4 million
- Number of employees 14,876

Air New Zealand

- Fleet 79 aircraft
- Number of destinations 48
- Countries served 15
- Passengers per year 6.4 million
- Number of employees 9,560

(Source: Star Alliance 1999)

The Star Alliance has a total of 1,858 aircraft and 282,348 employees. It is transporting 256 million passengers per year and more than 760 destinations in more than 112 countries are served. The numbers will increase when Austrian Airlines, Singapore Airlines and Mexicana Airlines are joining next year. (Star Alliance 1999)

4.2 Strategy

Each airline of the alliance is too small to set up a truly global approach (*Airfinance Journal* Jun. 1997b, p22). For them the alliance with other airlines gives them the chance of adding new destinations and markets without making substantial financial investments (Beirne 1999b).

One of the key elements of the alliance is to respond to customer needs. The customers have a strong preference for a single carrier service (Clarke et al. 1999). Thus they want to fly virtually to anywhere in the world and don't want to deal with more than one carrier. At the same time they want to have frequent flier programs and elite status. The partnership is responding to these demands by offering so-called seamless travel to the member-airline passengers (Taverna 1997). A broader choice of destinations, more convenient schedules, one-step reservations and check-ins and smoother connections are offered in order to meet the customers expectations (Taverna 1997). Intensified route coordination, code-sharing, integrated airport operations and cargo activities plus joint lounge usage and ticketing are in place to make the seamless travel possible (*Air Transport World* Jun. 1997, p10). Additionally

services like alliance-wide frequent flier status and real-time flight information are offered (Smith 1997). The alliance is adding value to the customers.

To make the benefits of the alliance known to the customers advertising is done under the common branding of the Star Alliance not only on aircraft but also at airports and in other media (*Air Transport World* Jun. 1997, p10). The advertising is done internationally showing the Star banner and promising things like airport lounges, mile accumulation, elite status and global access (Beirne 1999a). All made possible through the alliance and the customer can benefit from it (Beirne 1999a). The visual is consistent and is only adapted to language and cultural needs in each market (Beirne 1999a). The approach is aimed at building awareness for Star and the deliverable benefits (Beirne 1999a). Although there is a common branding the alliance partners don't give up their identities and there is no such thing like a common product (Feldman 1998).

While the alliance is adding incremental value for passengers there is also a focus that costs are not increasing (Smith 1997). Therefore cost-cutting measures and cost management is another key issue of the alliance (Taverna 1997). Cost savings can be achieved in areas like joint aircraft purchasing and by eliminating overlap and rationalizing capacity (*Airfinance Journal* Jun. 1997a, p18).

Another key issue is the presence in as many markets as possible. The adding of new partners from different parts of the world provides this presence to the alliance. This is necessary to offer the customers the service they want.

The goals of these strategies can be described as follows. To the customers the alliance has to appear as it would be one single carrier. Therefore the common branding and advertising but also things like alliance-wide frequent flyer points are used. It is aimed at gaining as many customers as possible. The market share is important to get economies of scale. Cost reducing is needed to provide demanded lower fares. Although there are undoubtedly benefits to the customer the main aim is to increase the airline's revenue and maintain a strong position of the alliance in the market. This is especially important because the competition has changed from single airlines to big airline alliances.

4.3 Evaluation

In the first two years since the alliance was established the members say that their profits have increased up to 10% because of the boost of business caused by the alliance (Geoffrey 1999). United claims the benefits from its Star Alliance membership attributed roughly US$ 200 million (10%) of the operating income in 1998 (Jarrett 1999). The latest revenue figures (prepared in October 1999) for the alliance and each airline are:

United Airlines	US$17.6 billion
Lufthansa	US$13.0 billion
All Nippon Airways	US$8.4 billion
SAS	US$5.2 billion
Air Canada	US$4.0 billion
VARIG	US$3.0 billion
THAI	US$2.7 billion
Ansett Australia Holdings Limited	US$2.1 billion
Air New Zealand	US$1.6 billion
Star Alliance	US$57.6 billion

(Source: Star Alliance 1999)

It is beyond the scope of this report to look at the results of every airline. Therefore only some figures of Lufthansa are discussed in the following.

Lufthansa's net profit in 1996 declined 63% compared to the previous 12 month in 1995 (*Airfinance Journal* Jun. 1997, pp20-23). Lufthansa faced problems in the German market because of a restrained economy, strong competition arising from European liberalisation and strike threats. The existing alliance with United and SAS has saved Lufthansa some US$113 million (DM200 million) (*Airfinance Journal* Jun. 1997, pp20-23). Lufthansa claims that Star founded in 1997 produced US$396 million additional revenue, US$226 million additional profit and 1 million more passengers in 1997 (Feldman 1998). But cost reductions are still badly needed and could be substantial (Feldman 1998). Although Lufthansa announced US$ 920 million in 1998 (Jarrett 1999) a record annual profit it still had a serious cost position (Hill 1998). This was mainly caused by excessive costs at German airports and very high labour costs in Germany (Hill 1998).

Due to the announcements of the airlines the alliance is generating additional profit for the airlines. In the case of Lufthansa the profit was increasing and reaching record

levels since the Star Alliance was formed. But there are two questions to be asked. The first question is, is this increase only or mainly caused by the alliance? As mentioned before the airline industry is cyclical. The last years were good time for the industry (Upbin 1997). It has to be observed if the results are staying at such a high level when the industry is slowing down again. The second question is how can the airlines be sure what part of revenue or profit is caused by the alliance? It is hard to qualify what financial benefits arise from pooling of commercial functions or the extension of a seamless customer service. The figures are looking good and it looks like the alliance is paying off for its members but the true quality of the alliance will show in its ability to reduce costs (currently the biggest problem of Lufthansa) and its performance during a slow down of the industry.

The common branding and advertising under the Star banner seems to work. Parts of the increases discussed can surely be related to the common branding and advertising. But these things also may or possibly will have a downside. The alliance is muddying brand identity, loyalty and even safety reputations. Airline brand identities painstakingly differentiated are commoditised (Beirne 1999b) distinguishing characteristics of the carriers get swallowed up by the brand, Star Alliance (Jarrett 1999). In an alliance the airlines are blending the one facet that sets them apart: loyalty programs (Beirne 1999b). Frequent travellers may find it difficult in the future to recognise their favourite airline (Jarrett 1999). And it might come to the point that customers select the airline based on which one is the closest and cheapest (Beirne 1999b). An airline has no distinct advantage if it competes on price or food in an industry where differences don't matter (Beirne 1999b). The question is will the groups be able to differentiate enough themselves to matter to customer (Beirne 1999b)? Another problem may arise from the cross selling of seats. The traveller who just booked a ticket is left wondering who will be the operating carrier on the flight (Relf 1999). Every airline in the Star Alliance has different policies and service levels. It is doubtful if the passenger accepts a lower or different service level than he or she is used to from his or her favourite airline when flying from one airline to the next (Beirne 1999b). It has to be observed if Star can avoid or solve these problems.

Another problem may arise from the composition of the alliance. There are three big airlines (United, Lufthansa, All Nippon Airways) and six smaller airlines. The smaller partners may feel like second-class citizens in the Star Alliance. United and Lufthansa seem to be difficult partners (Feldman 1998). "They combine arrogance, cynicism and

bitterness with a commanding market presence." (Feldman 1998) This makes it challenging for the smaller partners but it is immensely rewarding not only in money but also in things like for example the implementing of eticket. Smaller airlines don't have the resources to implement such things alone (Feldman 1998). Keeping the alliance together might be a problem if the smaller airlines start to think they would be better off elsewhere. This makes clear that alliances are not stable there will be serious problems when an airline leaves and perhaps swaps to another alliance (Jarrett 1999) especially because the members of Star Alliance can leave the alliance at short notice (Beirne 1999b).

Although there are some things need to be observed and some to be sorted out it really seems that Star Alliance is working and is paying off for its members.

5.0 Conclusion

Some estimate that in the future there will 4 – 6 global alliances with aligned regional niche carriers (Clarke et al. 1999). This depends on whether the alliances are managed well and kept together or not. On the other hand it largely depends on governments. Governments can change the existing bilateral air services agreements to make mergers and acquisitions possible. This might lead to acquisitions of smaller carriers and mergers of the bigger ones. It is likely that governments will change these agreements because of the effects of the alliances on competition. Especially the European Union regulators are concerned about this matter. (Shifrin 1997) At the moment it seems that the alliances in the airline industry offer a flexible and profitable option for the carriers to grow and expand into new markets. Therefore it is likely that they will dominate the picture in the next couple of years.

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