

Embracing and Exploiting Industry Turbulence: The Strategic Transformation of Aer Lingus

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Turbulence has become a constant, with an oxymoronic 'predictable unpredictability' nature. What does this mean for enterprising, visionary chief executive officers (CEOs)? Turbulent industries presage that CEOs need to react ever faster and more creatively to take opportunity of the risk to which their competitors are exposed. The Aer Lingus case demonstrates that the need for effective, path creating leadership in corporations has never been greater. The airline's needs enabled the expansion of its leadership capacity by developing opportunistic vision, versatility and connectivity. Leaders can start to embrace turbulence and release value by moving along the cost-service continuum as a process to improve productivity and regain market momentum.

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Introduction

Senior business executives face intense and ever shifting challenges as they strive to lead their organi-

zations in business environments increasingly characterized by turbulence (Lawton, 2003). This turbulence is expressed in market related instability such as shorter innovation and production cycles, ever greater product multiplicity and shorter planning horizons. It is equally manifested in the commercial confusion caused by global terrorism, localized wars, rising oil prices and deep-rooted uncertainty about the world we live in. A new norm has emerged, where turbulence is no longer an extraordinary or even cyclical event. Turbulence has become a constant, with an oxymoronic 'predictable unpredictability' nature. What does this mean for enterprising, visionary chief executive officers (CEOs)? Turbulence is an immense opportunity to move ahead, often in a transformational way. Turbulent industries presage that CEOs need to react ever faster and more creatively to take opportunity of the risk to which their competitors are exposed. The Aer Lingus case study detailed in this paper demonstrates that the need for effective, path creating leadership in corporations has never been greater. The airline's needs enabled the expansion of its leadership capacity by developing opportunistic vision, versatility and connectivity (Volberda, 1999). Although it is an implied assumption that strategic

leaders are the guiding strength behind organizational value creation (Finkelstein and Hambrick, 1996), we delineate the specific behaviors and mechanisms through which specific leaders have an impact on value creation through exploiting turbulence. What is more, industries that have regular patterns of turbulence highlight the challenge to modern CEOs of adopting consistent market positions and configuring organization resources that together generate profit with shareholder return. We believe that leaders can start to embrace turbulence and release value by moving along the cost-service continuum as a process to improve productivity and regain market momentum.

The Nature of Industry Turbulence

In the early 1990s, European airline giants like British Airways (BA) and Lufthansa, along with medium sized national flag carriers such as Iberia and Aer Lingus, came under attack from relative newcomers, easyJet and Ryanair (Lawton, 2002). Rather than embrace the full-service, hub-and-spoke strategy of the major airlines, the innovators introduced a low-cost/low price, point-to-point, no-frills strategy that proved to be a hit with European consumers (Doganis, 2001). Before long, they had captured a large segment of the market, and the established airlines in Europe were searching for answers to the market threat. The historical evolution of the airline industry has polarized the nature of strategy within the European market. Although the flag carriers have competed on price to some extent since deregulation of the industry in 1997, the emphasis on quality and brand differentiation as means of securing a competitive advantage has continued (IATA Annual Report, 1997). Service superiority and prestige are not compatible with bargain basement prices and traditional carriers in Europe have allowed a new breed of ‘no frills’ carriers to adopt the opposite strategy, predicated on cost-minimization, largely unchallenged.

The managerial processes or routines that a company develops are path dependent and this can act as a constraint to wholesale innovation and positioning in the market, because routines can only change incrementally and cannot have a clean break from the past (Nelson and Winter, 1982; Teece et al., 1997). In other words, inertia and myopia result from vast management structures and entrenched routines (Besanko et al., 2000). This strategic void has begun to be filled by those who are willing and innovative enough – low fare airlines (LFAs). For instance due to their lack of history and organizational baggage, there are no established routines to constrain innovation and change. The ability and willingness to innovate has in fact played a large role in creating a competitive advantage for corporations like easyJet and Ryanair. What does this mean for corporations that are laggards in their industries? Companies need to be quick in their innovation strategies (Markides, 1997), consistent in implementation and embrace turbulence so as to leap-frog other corporations in the market. The leader must interpret the turbulence quickly and then exploit the window of opportunity faster than other competitors.

From Turbulence to Impulse

When Willie Walsh took the helm at Aer Lingus in 2002, he was under no illusion as to the scale of the challenge he faced. No one associated a spirit of enterprise with long established State owned corporations like the Irish national airline. Change management, difficult in the most adaptive organizations, tends to be far more arduous in corporations that have government as the sole or majority shareholder (Doppelt, 2003). The triple themes of cost reduction, effective service quality and profit maximization – core principles for private enterprise – have traditionally been only loosely adhered to by State owned enterprises (Doganis, 2001). Externally, the challenges to the business were increasing at a tremendous pace. A cloud had gathered over the entire

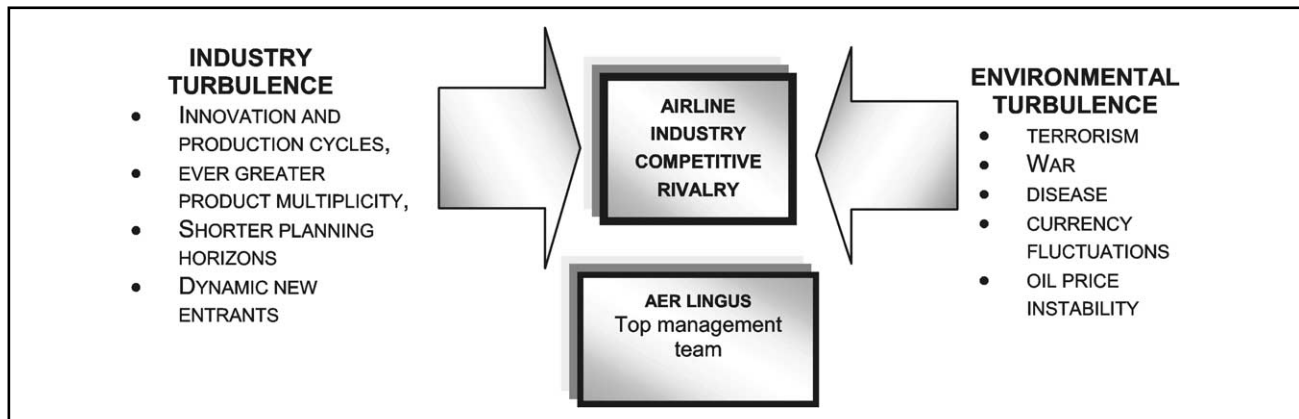


Figure 1 Factoring Turbulence into Organizational Decisions and Direction

industry that rendered a sense of urgency that no previous Aer Lingus CEO had faced (see Figure 1).

Global terrorism, transnational infectious diseases and above all, the competitive threat posed by LFAs, had taken a tremendous toll on the revenues and market share of national airlines. Aer Lingus posted an operating loss for 2001 of €50.4 million (US\$49.5 million), compared with a profit of €79.0 million (US\$78.5 million) in 2000 (Aer Lingus Annual Report, 2003).

Turning Turbulence into Opportunity

Walsh's response was immediate and his vision was clearly shaped and consistently delivered. The CEO's statement in the 2001 Annual Report is indicative of Aer Lingus' long-term goals and objectives. In it, Willie Walsh states that:

Conceptually, this is a simple business. In the past many airlines, Aer Lingus included, have been guilty of over complicating it. Aer Lingus is changing this strategy.

The company effectively redefined its mission statement, asserting the need to achieve sustained profitability through commercially viable products and practices involving a keen customer focus. The new strategic direction that Aer Lingus adopted was one of catering for all sides of the aviation market. Essentially, they were competing with the Ryanair model, in an attempt to capture increased market share in a growing segment, while still providing the service, for which they were renowned (Lawton, 2002). Aer Lingus was beginning to realize that there were consumers who did not need a sandwich, a drink, or an Internet connection on board; they just want to get to their destination safely and cheaply. Aer Lingus was always a customer focused company, but was now finally becoming more market focused.

With the arrival of competitors like Ryanair and easyJet, competition had increased, resulting in a noticeable difference in price (McWilliams, 2001). Aer Lingus was now committed to getting customers to their destinations as cheaply, simply and efficiently as possible (O'Toole, 2004). Aer Lingus' strategy was a twin track one, namely to offer cheaper fares while maintaining its reputation as a service-oriented airline, where appropriate. In tandem with this, the company aimed to continue to drive down costs and introduce more cheap fares. The company was no longer locked into the traditional ways of doing things and had taken the view that it is more important to fly to destinations where the consumer wants to go.

This strategic re-positioning was partly in response to a number of internal and external factors that had whittled away company profits. These included

industrial relation disputes, the impact of the foot and mouth outbreak and the bad press surrounding former CEO Michael Foley – in addition to the deepening global economic downturn (O'Toole, 2004). These necessitated a sharper examination of company direction and strategy implementation. Aer Lingus could not cope with sharp falls in revenue: it is capital intensive and needs to maintain a network, which means high fixed costs. An airline must, on average, fill three quarters of its seats to make any money. Moreover, aviation is a highly political business – particularly in a region where governments often own large amounts of shares in their national carriers (Brown, 1987). Issues of national pride and employment have long outweighed financial logic. Historically, carriers that have failed were propped up with State money. The result has been a plague of overcapacity and weak profit margins. Carriers have not exited the industry but instead, have been recapitalized. Following on the final phase of European air transport liberalization in 1997, the European Commission made it increasingly difficult for governments to bail out their airlines (Stasinopoulos, 1993; Doganis, 2001). Times had changed but few State carrier top management teams accepted this fact willingly or rapidly. Walsh was the first to do so at Aer Lingus.

Overhauling Structure and Strategy

The principle of keen customer focus had been embedded within the Aer Lingus ethos from the company's inception. The carrier developed a reputation for friendliness and service, enabling them to win countless accolades over the years. It was precisely this competency that Walsh desired to exploit and build on while providing low prices to enhance the average perceived value to the customer when compared with budget airline competitors (Connolly, 2002).

With the strategic intent of building on low prices with consistent quality in service, Walsh began by immediately halving the business-class fares that had been the premise of the airline's life as a flag carrier. For instance, the airline's premium return fare from Dublin to Brussels was lowered from €1,000 to €498 (O'Toole, 2004). At the same time, Walsh realized that the yield had duly tumbled, causing a 7% fall in revenues along the way. But he stood by his new business model, arguing that it was a more accurate picture of what the real underlying demand was for a full business product.

Walsh had never doubted that the low-cost sector was here to stay and he consequently began to benchmark very assertively against low cost airlines. In the past, Aer Lingus used to benchmark against traditional flag carriers. Walsh came to grips with

the reality that the carrier was being driven by the customer and what they want and are prepared to pay for, whereas in the past, the focus was less on customer needs than on providing elaborate service. As a result, Walsh reduced the complexity within the corporation that already helped bring overall costs down by 30% (Aer Lingus Annual Report, 2002). The smart benchmarking by the Walsh executive team demonstrated that Aer Lingus was at a monolithic cost disadvantage against Ryanair, representing more than €20 per passenger per sector (Walsh, 2003). In addressing the colossal cost of sales and distribution, Walsh focused on cutting travel agents commission and increasing online reservations.

His approach proved highly successful in just two years, Internet bookings climbed to more than half of all ticket sales. Approximately 40% of ticket sales outside the Irish market are made over the web and the figure stands at over 60% at home, across all services and tickets (O'Toole, 2004). The figures represent over €1 million of revenue per day – and still growing. Walsh wanted to take the online share

up to around the 70% mark. Aer Lingus still handles 10–12% of sales through call centers and keeps some business fares available on the computer reservation system (Business and Finance Magazine, 2003).

The model that Walsh adopted was one of catering for all sides of the aviation market. Essentially, the new Aer Lingus business model had some aspects of the Ryanair approach but it was not a pure low-cost carrier, as it still provided an elevated quality of service, for which they are renowned (Lawton, 2002). Walsh believed that not moving with the swift change in market trends could be hazardous – particularly in a business historically reluctant to change. With this in mind, he decided Aer Lingus should have a twin track strategy, namely to offer cheaper fares while maintaining a reputation as a 'full service' airline – where this did not cost much. Moreover, he believed that the key to success lay not in providing an elaborate service but in being consistent. In tandem with this, the company continued its cost reduction initiatives and fare reductions. Walsh had taken the view that it was more important

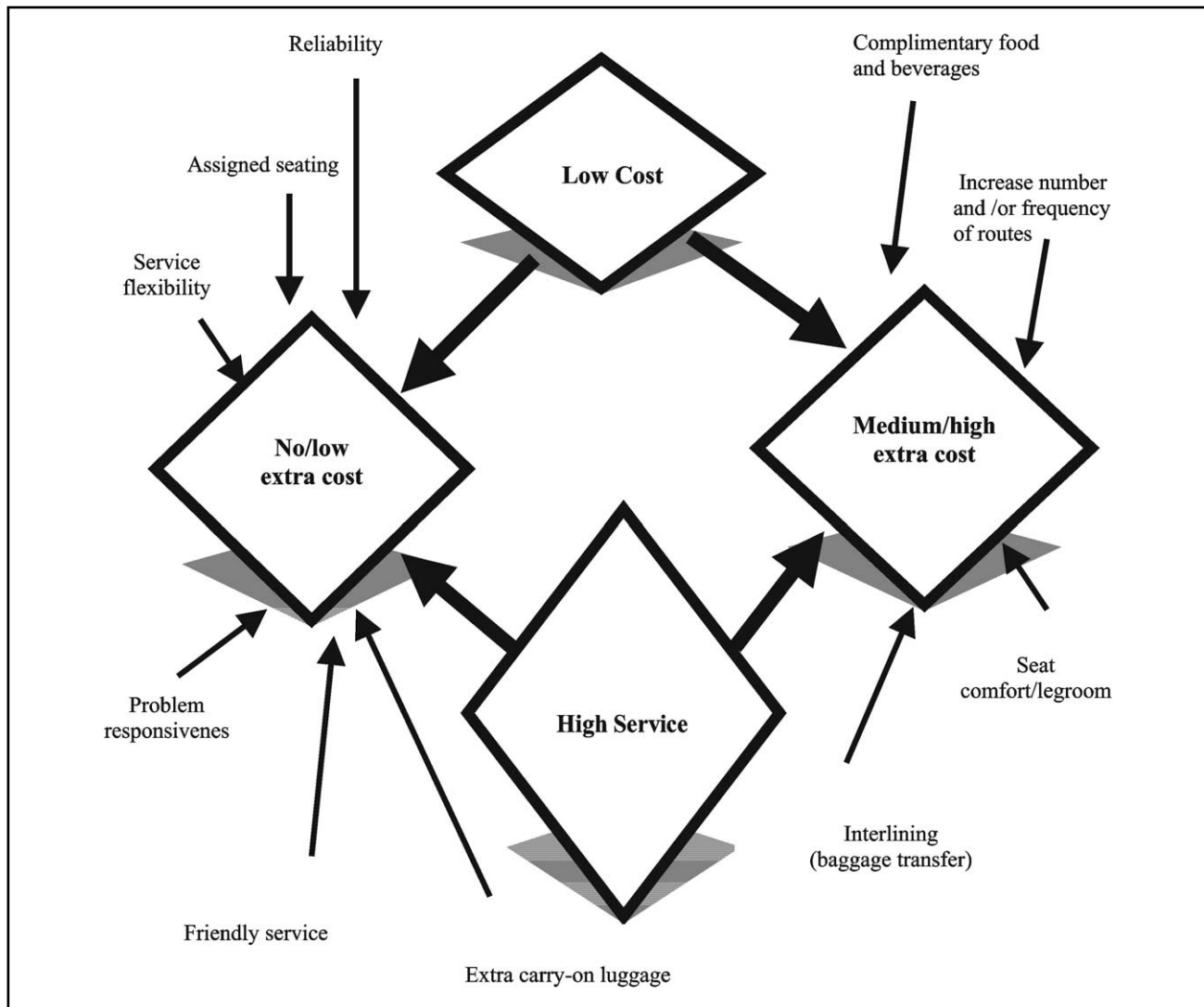


Figure 2 The Cost-Service Balancing Act

to fly to destinations where the customers wanted to go, rather than where a legacy route existed. He added 30 new routes to the airline’s European network, closing four historic loss-makers and experimenting with new, often leisure-driven services (O’Toole, 2004). An example of the new routes was from Dublin to the Spanish mass-market beach resort of Malaga, routes that the old Aer Lingus would never have been associated with. But it was clear that others were making money in these markets.

Walsh emphasizes the points of difference that give the carrier an edge in terms of service. These center on four simple key benefits: friendly service, assigned seating, flights direct to main airports and the promise never to leave the passenger stranded (see Figure 2). He stipulated that advertising in the past may have focused on the luxury of business travelers but that was no longer viable and realistic. In the past, Aer Lingus promised more than they could deliver but now they delivered what was needed.

Walsh believed his business model of quality service and product consistency, allied with cheap fares, would win over the doubters by creating greater perceived value than competitors in the eyes of the consumer. If you can offer free intangibles by allowing people to take extra hand luggage onboard – space permitting – at no extra cost, it will indirectly increase the perceived value of their product (Figure 2). Furthermore, if a customer misses his or her flight or suffers from a cancellation, they can get the next available flight – space available – without any extra cost. Such service propositions increase the perceived value for the customer, which increases brand loyalty and ultimately, revenues.

The Recognition of Turbulence at Aer Lingus: Walsh’s ‘Triple A’ Approach

The Walsh transformation strategy had three components – the ‘triple A approach’ (Figure 3): *Acceptance* of the changing environment, *Action* phase, *Adherence* and consistency in value creation.

Acceptance of the Changing Environment

Nearly every carrier worldwide has tasted the reality of deflated earnings after the attacks of September 11th 2001, the Bali bomb blast, war in Afghanistan, war in Iraq and the SARS epidemic (Sheehan, 2003). Many airlines in Europe and the US were slow to comprehend the scope of the multi-headed calamity that had engulfed their industry (AEA Annual Report, 2004). Walsh grasped that this time things were different and that the turbulence that had been building for some time had finally reached a point of no return. He correctly assumed and accepted that bankruptcy was a very real possibility, after Swissair and Sabena failed. In accordance with understanding the market environment, Walsh did something that no European or American counterparts did: he benchmarked against the real competition, Ryanair, rather than against the other legacy carriers. Unlike United Airlines for example, which set Delta’s costs as its benchmark, Walsh correctly perceived that they had to re-position themselves in the market and modify their business model, if they were to avoid the usual pattern of reaching a targeted goal only to find that the savings were insufficient and the process was to be restarted. Unlike almost everyone else, Walsh perceived that the new model had to focus not

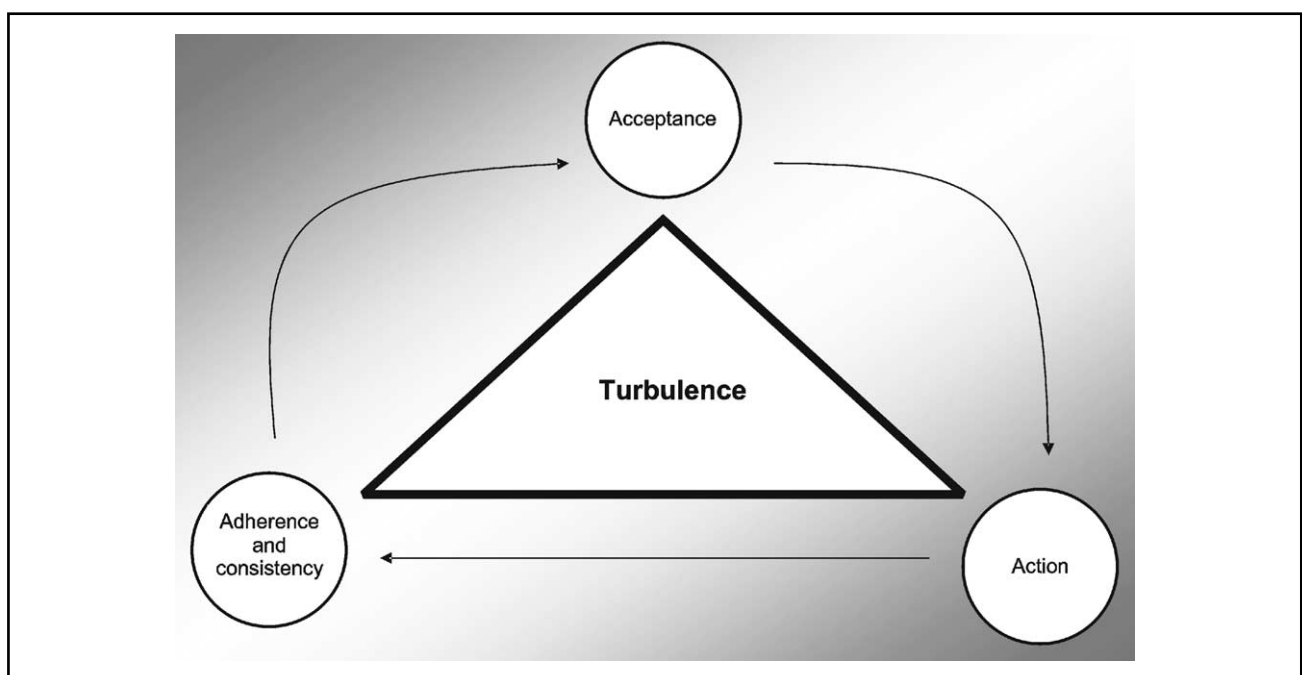


Figure 3 The Triple A Approach to Embracing and Exploiting Turbulence

on the traditional competitors, but on the low cost airlines that posed the greatest threat to the survival of mid-sized carriers like Aer Lingus.

The Action Phase

This acceptance led to an instant reaction. The restructuring program was more rigorous and had significantly more substance than anything undertaken by Aer Lingus' competitors. Furthermore, the implementation and timing was correctly executed by Walsh, unlike many of his competitors. There were no half-measures undertaken and the transformation that was begun was designed to achieve a fundamental restructuring rather than alleviate a singular downturn. These strategic actions included (Aer Lingus, 2003):

- ❖ Cost reduction of €190 million, 16% of the cost base, achieved through reducing staff by 2,000 or 40%
- ❖ Booking costs fell by 40% as online booking increased
- ❖ Temporary pay freeze for pilots
- ❖ Reduction of leisure fares by more than 50%
- ❖ Increase capacity at these fares to over 50%
- ❖ Reduce business fares by more than 50%
- ❖ Realign capacity with demand to stimulate traffic
- ❖ Revenue management focus shifted to load factor
- ❖ Reduction in commissions to travel agents
- ❖ Fleet reductions and increased utilization
- ❖ Network analysis and reconfiguration
- ❖ Concentration on direct web marketing

Adherence to and Consistency in Value Creation

Lastly, and most significantly, Aer Lingus fully embraced the idea that this new model was not a one-off event but an ongoing strategic process, constantly dynamic and never complacent. Aer Lingus would seek to constantly drive down costs and focus only on those services that were 'cost light' (Figure 4). One of the points often repeated was the fact that the actions already taken were only the opening rounds of an ongoing battle to reduce cost, maintain quality and increase efficiency. The Aer Lingus top management team admitted that their current position remained short of being fully competitive with Ryanair. However, they had a clear vision of that gap and a strategy to cope with its presence. The first aspect is to continue to reduce costs and narrow the differential. The other part of the strategic plan is to create additional value in the Aer Lingus brand, giving substance to any fare differentials that may exist. Especially important to Aer Lingus is the customer service component, a point at which they judge arch rival Ryanair to be most exposed.

Changing the corporate culture inevitably proved the most significant challenge for Walsh. Radical downsizing always creates fear and uncertainty, but one of the interesting obstacles was the purposeful use of the word 'cheap' to describe the new Aer Lingus product. Seen often as a desirable attribute from the customer perspective, internally it unleashed all the negative connotations and associations that network carriers associate with the low-cost segment. Other changes were equally suspect. Aer Lingus had previously, like most traditional carriers, entered new markets only after substantive study and anticipating a development curve, begun at a loss, with a

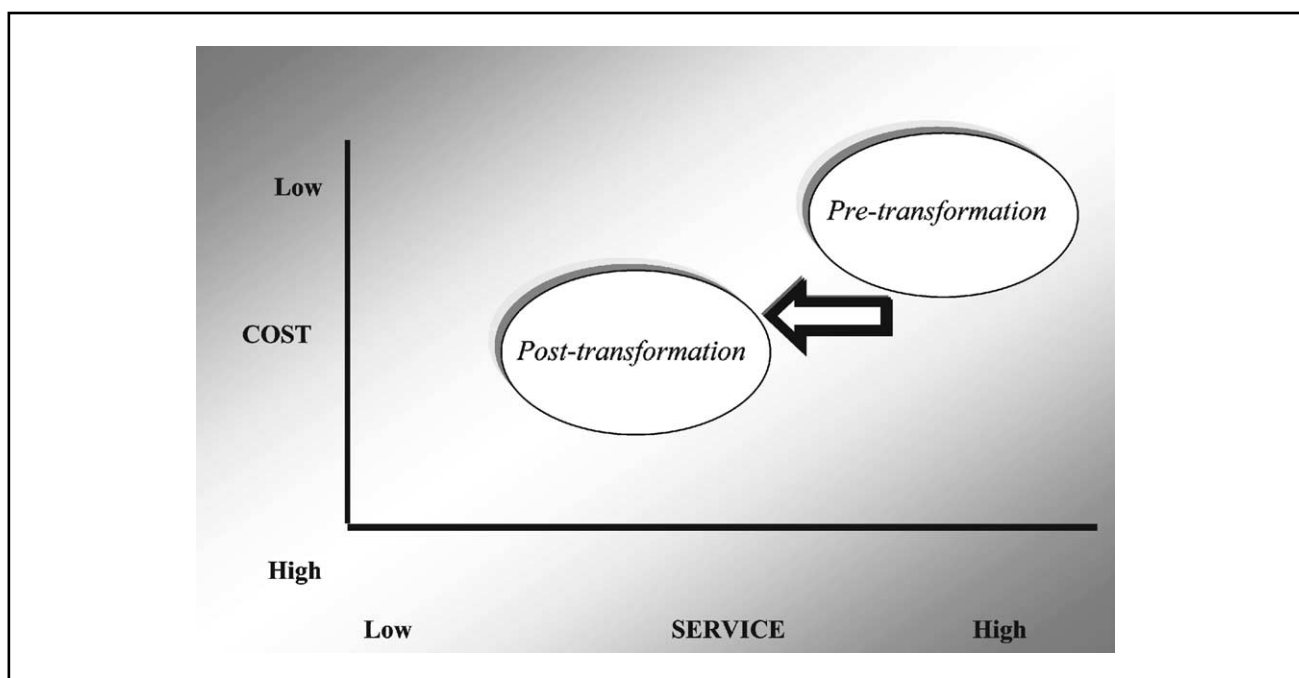


Figure 4 Business Transformation and the Aer Lingus Cost-Service Continuum

two to three year period allowed for route profitability. Clearly, few airlines are any longer in a position to move so slowly towards profitability. Aer Lingus abandoned this established route development plan and simply inaugurated service to new, promising destinations – most clearly outside the established Aer Lingus pattern (Aer Lingus Annual Report, 2003).

Keep Your Seat Belts Fastened, Turbulence Remaining

Ultimate proof of the turnaround strategy's sustainability came after the implementation of the survival plan that saw a return to profits. It was evident that the announced plans to layoff 40% of its workforce and reduce its cost by €190 million (\$186.7 million) was justified. Aer Lingus had turned in operating profits of €64 million (\$82 million) for 2002, equivalent to a margin of 6.6% on revenues that had dipped just under €1 billion (Aer Lingus Annual Report, 2002). For 2003, that rose to more than €75 million – a margin approaching double figures. Walsh's focus on costs made the airline leaner, more flexible and more competitive. In approximately six months, he turned a significant loss into an altogether unexpected profit, when Aer Lingus announced a €14.3 million operating profit for the half year period. The figure compares to losses of €38 million and €12.6 million in the same periods of 2001 and 2002 (Aer Lingus Annual Report, 2002). The Walsh leadership team had turned Aer Lingus into a role model for similar sized airline companies, both in Europe and around the world. However, turbulence remained and some of it was beyond the control of any one management team. By 2004, major consolidation was underway in the European airline industry, with the KLM/Air France merger heralding the beginning of a shift towards bigger and fewer, even among Europe's national flag carriers. This trend, actively supported by the European Commission, means that in the event that Aer Lingus is privatized – something mooted by government sources on a regular basis – there is a distinct possibility that it will be taken over by a larger carrier. Aer Lingus is a small peripheral player in global terms, although its business could prove attractive to a North American airline keen to use it as a hub into Europe. The appointment of Walsh as CEO of BA in 2005 opened another future scenario: the acquisition of Aer Lingus by its much larger Oneworld alliance partner. As such, the business environment will continue to be a cause of uncertainty. Deregulation will spread to regions of the world hitherto untouched. The ownership rule requiring airlines to be substantially owned and effectively controlled by nationals of their country of registration will be under pressure and is likely to be progressively abandoned. The 2004 expansion of the European civil aviation area to encompass an additional ten States created new opportunities but

also threats for many of Europe's airlines. The airlines of the new Member States, largely government-owned, face the full force of open and free competition domestically and internationally for the first time.

There is little doubt that the airline business is changing rapidly and that carriers must evolve or risk extinction. In the Darwinian evolutionary race, it is not necessarily the strongest that survive but the most adaptable. The Aer Lingus management team led by Willie Walsh proved that this was possible even in the highly competitive and rapidly evolving air transport business. The subsequent choice of Walsh to run BA, a company ten times the size of Aer Lingus, indicated that Walsh's visionary leadership and transformational capabilities had not gone unnoticed in the wider business community.

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