SAA AND THE SOUTH AFRICAN AIRLINE INDUSTRY
THE NEXT TEN YEARS - 2012-2020

INDUSTRY FORECAST

Domain: SAA and the South African Airline Industry, the Next Ten Years.
Time Horizon: 2012 - 2022

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Executive Summary:

SAA finds itself caught in an industry that is rapidly changing towards a low-cost, variable-cost market. However, due to the political and national interests associated with SAA, as well as its entrenched strategic position as a mainline, international, full-service carrier, SAA is unlikely to be able to make the changes necessary to ensure profitability within the current framework. It is the recommendation of this paper that SAA explore alternative structures through deregulation, such as private, public partnerships, to unbundle the airline, while maintaining key strategic contracts that serve the national interests. Furthermore, from this new position of competitiveness, SAA explore a leadership role in the airline industry on the continent, given the rising role of emerging markets globally. Two scenarios, “SAA Grounded”, and “SAA Takes Flight” depict these perspectives below.

Current Conditions:

The domestic Airline industry in South Africa is currently an oligopoly, "a market with limited competition, shared by a small number of suppliers." Furthermore, it is a “network infrastructure industry”, as a result it exhibits the following characteristics; barriers to entry for new entrants, few sellers of products and services, similarity of product between sellers, economies of scale where costs diminish with market share, growth through merger is an attractive venture, mutual dependencies exist between competitors, price rigidity and non-price competition entrenches market shares, and price transparency and collusion is highly likely.

Due to the state-ownership of South African Airways (SAA), the airline industry is not a level playing field, with government competing with a strong hand against the private sector. By way of example, SAA has been found guilty of "predator behavior" and "abuse of "dominance", while state funding support for SAA has skewed the market, giving SAA unfair advantage.

Yet, despite these and other negative characteristics, the industry has shown a six percent passenger traffic growth over the last year.

Competition comparison:

Currently, seven major domestic airlines share the domestic market, and a number of smaller charter airlines operate on less dense routes. SAA, with 35% market-share, is Government owned and has been in existence since 1934. Prior to economic deregulation of the airline industry in SA in 1991, SAA dominated with 95% market share. At early stages, SAA controlled all high density routes, without competition. The industry was deregulated in the early 1990's, based on the Four Principles of the "Domestic Aviation Policy of 1990:

1) Safety is of utmost importance
2) Economic decisions should be resolved by market forces
3) User interests and perceptions must be taken into account, and
4) All industry participants must be treated equally in terms of legislation, rules, and opportunities.

After deregulation, Comair successfully entered the market in 1992, entering a franchise agreement with British Airways in 1996. Phoenix Air and Nationwide subsequently entered the market but ended in bankruptcy, partly due to unfair practices by SAA, in lieu of which a R 40million abuse of dominance was granted by the Competition Authority. Kulula.com was established by Comair in 2001. Thereafter, 1Time entered the market in 2004 to compete with Comair's Kulula.com. SAA established Mango in 2006, to compete with itself and the private entrants in the Low Cost segment. Low Cost airlines centre on the Golden Triangle routes (Johannesburg, Durban, Cape Town), of which SAA holds 34% market share.
Growth in passenger numbers and aircraft activity is attributed to; the "price war" which ensued, increased disposable incomes, and aggressive marketing efforts by the Low Cost Carriers in the last decade. However, the SA Aviation Authority estimates that if Airport charges were to increase, the market may shrink as much as 70% as rates become unaffordable to the emerging market.

Recently, the State has again given SAA a "bail-out" of R 5 billion, effectively prolonging the unequal relationship between competitors. In addition, SAA's entire Board and CEO has resigned, and a task team set up by the minister to develop a strategy for SAA's future, signaling turbulence both in the industry and the state-owned enterprise itself.

**Airline Industry Traits:**

The domestic airline industry is marked by the following six traits:

- The industry is prone to high sensitivity to economic fluctuations
- The doctrine of "sovereign national airspace" affects state willingness to privatize the industry.
- The doctrine of "cabotage", excluding foreign airlines on domestic routes limits foreign direct investment.
- The practice of "public ownership of national flag carriers" makes the state prone to ownership and interference in the industry.
- High infrastructural and asset investment is required of entrants, creating barriers to entry and operational cash-flow challenges.
- High networking exists between government, regulators, and competitors, creating a small club within the industry.
- Rigid cost structures exist, making pricing inflexible and uncompetitive.
- Strong emphasis is placed on yield management to achieve efficiency, requiring investment in information technology, systems, and training of staff.
- Prominent role of marketing strategies is evident, making for a competitive environment on the demand side.
- High switching cost and lock-in effects (contracts, training, learning, data conversion, search costs, and loyalty costs) exist, binding suppliers into existing relationships.

Many of these traits directly dampen free market forces, resulting in uncompetitive, unsustainable management practices, as demonstrated in the case of SAA.

**Stakeholders:**

Due to the government ownership of SAA, the South African public is a notable stakeholder in the industry. The failure of SAA to perform over the last decade is a major ethical issue and presents notable issues round the constitutionality of government payouts in bolstering the state owned enterprise.

**Eras:**

Four recognizable eras mark the development of the industry:

- **Regulatory Era**, prior to 1991: Where SAA dominated the industry with 100% state ownership.
- **Early De-regulation Era**, the 1990s: Where early competitors took SAA on head-on and mostly failed.
- **Low-Cost Arrivals Era**, the 2000s: Where low cost competitors grew the market, competing with SAA through diversification.
- **Mixed-Cost Competitors Era**, the 2010s: Where entrenched airlines can experiment with various offerings, while having to cope with unprecedented fuel price hikes.
Baseline Forecast:

Constants: The constants in the industry are that;
- Airlines provide an essential service to the economy.
- Difficulty to enter the market, exasperated by limited access to crucial facilities, will continue to limit private entry.
- Sunk and unrecoverable costs spent by the state on SAA in the part will cloud the airliners future, and cast a shadow of lack of confidence in the sector.
- The natural monopoly enjoyed by SAA will continue, while the airliners lack of profitability will likely continue.

Trends: The following trends are shaping the industry domestically:
- New entrants continue to seek entry to the market, almost entirely in the low-cost segment, of which four have folded already.
- Two new Airlines launched in the last twelve months, one of which has gone bust.
- A much greater range of choices among airlines exists than in the past.
- New business models are being developed, low-cost airlines being an example.
- Growth in the domestic market persists.
- The South African industry has been on par with global growth rates, with Johannesburg as a "key gateway to the continent", driving growth.
- Global trends include; a movement towards "mixed-cost" offerings and business models.
- Mixed fortunes exist globally in the industry, resulting in a decline in industry confidence, driven by fuel prices, flattening demand due to weakening demand-supply conditions.
- The evolution of “strategic cooperation among airlines” as a means to compete has emerged.

Factors and Indicators: Various political, economic, social, technological, and environmental factors impact on the industry

Political Factors:
- The impact of the "New Growth Path" is yet to be explored and fully understood.
- Policy Changes relating to the Organs of State will effect the relationship between SAA and the state.
- Developments in the Arab States and Europe, will affect the market and business with the region.
- South Africa’s inclusion in BRICS, will impact on economic cooperation and market growth.
- Government’s call to keep aviation charges down places pressure on the already marginal revenues in the industry.
- A piecemeal approach to negotiated “exchange of fair traffic rights” persists as opposed to “free multilateral grants”.

Economic Factors:
- European double-dip recession has slowed growth in the industry.
- Increased domestic competition has produced a price war and slashed revenues and margins.
- Increasing Oil, and resultant fuel prices, a major cost to the industry, have reduced margins.

Social Factors:
- Labour Union strikes negatively affect the economy and the industry.
- Low literacy, and high unemployment and poverty slow entry to the middle class and resultanty to the market.
- Slow industry transformation limits capital investment and development of the industry.
- Growing middle class and demand has been the stabilizing factor for the last decade.

Technological Factors:
- Rapid aircraft and aerospace technology advances imply ongoing investment required in the industry to remain competitive in the long run.
- Legal and Regulatory Factors:
Various conflicts between the Act and other legislation, including the Constitution, relating to "grey areas among entities", "ambiguity relating to accountability and co-ordination of mandate" will increasingly place government under pressure due to their stake in the industry through SAA.

**Environmental Factors:**
- Climate change affecting weather and flight patterns will affect customer satisfaction and ultimately profits.
- Emissions regulations may effect operations and demand.
- COP17 resolutions will effect airline's environmental footprint in the long run.

**Alternative Futures:**

**Trend Reversals:**
- New entrants are likely to continue to seek access to the market, possibly with an increase in international interests, as the emerging markets and Africa remain attractive. Such entrants, financed from developed nations, would have deep pockets, and likely to able to weather the competition with SAA.
- Due to past bankruptcies, new entrants are likely to be more circumspect and risk-averse, doing thorough due diligence prior to investing.
- High levels of competition and lower margins are likely to alter the trend from full-cost vs. low-cost, to variable cost alternatives in terms of product and services, leading to greater diversification and "value-added" sales strategies.
- Business models will steer further away from the conventional "centralized, spoke" approach, and be tailored around reliable growth segments.
- Domestic growth will continue despite economic uncertainty, driven by the undersupply of alternative transportation options that are safe and reliable.
- International growth is likely to shift from first-world tourism to emerging market business travel.
- Strategic cooperation among airlines to reduce costs and raise profitability will increase hegemonies.

**Potential Events / Wildcards:**
- Political instability in the Middle East around Iran may result in extreme oil-price shocks, and place the industry under enormous pressure.
- Technological breakthroughs in the area of green/alternative-fuel may radically alter the fuel dependance of airplanes and require a complete technological overall to compete in the market in the future.
- Political and Social instability in South Africa may stall economic growth and drive demand down.

**Issues, Dilemmas, Choices:**
- Government involvement is SAA is likely to persist, but amid growing discontent over the dependancy of the enterprise on public funds, and the inability of the entity to remain profitable.
- The strategy of SAA, as national carrier and owner of low-cost alternative, Mango, will be brought into question as the competition with itself weakens its own market share and reenforces the trend towards low cost flights. Given the short distances within South Africa due to the geographical nature of the country, the old model of full-service flights is likely to come under increased pressure.

**Key Uncertainties:**
- Soaring or stabilizing fuel and operational costs.
- Strategic agility of SAA to adapt to market conditions and the degree of Government involvement.
Scenarios:

Scenario 1: SAA Grounded

It is the year 2020, and the Annual Report of SAA has been released to the public amid massive public outcry. The last decade has seen SAA fail to come to terms with the changing conditions in the airline industry, and resulted in a strategic misstep by the airline. Political pressure to “save face” and bureaucratization of the enterprise due to state interference, has degraded the efficiency of the airline to the point of irreversible decline. Yet another government “equity injection” proved fruitless, and the enterprise hemorrhaged costs, failing to keep capacity levels above 70%. Aggressive pricing strategies were too late to retain customer loyalties as declining service levels eroded customer satisfaction. The lack of profitability finally drove government to explore privatization, at which point investor confidence in the tumultuous industry, meant government was negotiating from a position of weakness. A settlement was finally met whereby a Chinese consortium bought a controlling share in the airliner, agreeing to maintain the “South African Airways” brand, but limiting it to key international and domestic routes. By all considerations, the bold SAA of the 1990s had been grounded.

Scenario 2: SAA Takes Flight

It is the year 2020, and the Annual Report of SAA has been released to the public amid a wave of positive sentiment over the forethought exhibited through the process of rapid deregulation of the industry. A series of public-private partnerships allowed for the re-capitalization of SAA and establishment of a diversifies strategy of low-, varied-, and full-cost alternatives. A “reprieve” of 5 years was granted for existing competitors on key routes, after which the new SAA, publicly owned, with key contracts to the State, would compete outright. Breakthrough technologies in alternative fuels have made their appearance in the flagship fleet of the carrier, with SAA’s “green jumbo” being used strategically to lead the nation’s charge in environmental awareness. Through the process of rejecting another “turnaround” strategy, and embracing a “re-think” of participation in the airline industry in an emerging market, SAA set the tone for the formation of African Air International, a continental powerhouse able to compete in the international arena. As in other instances, South Africa, through her national carrier, has again set the pace for international change. OR Tambo is selected as the venue from where African Air International, the brain-child of SAA, took flight.

Information Sources:

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