Network of International Business Schools

WORLDWIDE CASE COMPETITION

Sample Case Analysis #2

Qualification Round submission from the
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Case: *Ethiopian Airlines: Bringing Africa Together*

ETHIOPIAN AIRLINES

Bringing Africa Together

Submission prepared for the Qualifying Round of the
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Introduction

Ethiopian Airlines (Ethiopian) wants to leverage its existing competencies to successfully realize the goals of its five-year strategic plan. To compete in the thriving African aviation market, Ethiopian must determine where and how to successfully grow its hub-and-spoke model (HS).

External Analysis

Africa's economic conditions have improved in recent years, illustrated by gross domestic product (GDP) growth rates ranging from 4.64% to 8.28% across Northern, Middle, Western, and Southern regions. Concurrently, urbanization rates, middle-class population and buying power are growing throughout the continent. This increases the ability for people to travel and can potentially further fuel Africa's thriving aviation market.

While African airlines only hold 20% of the intercontinental aviation market, low competition from non-African carriers in the intra-continental market creates the opportunity for them to secure market share within the continent. However, many African airlines are prevented from accomplishing this due to high operational costs, government regulations, underdeveloped infrastructures, and aging fleets. The emerging trend of major African airlines joining global alliances is helping these players to access the extended networks that allow them to further service existing networks and expand their reach.

Given the high operational costs which drive high fares, competitive advantages depend upon an African airline's ability to offer strong value through quality service. The ability to deliver safe service, something particularly in the Middle African region, is a potential opportunity to capitalize on. Receiving the IATA Operational Safety Audit certificate would be a major asset to a carrier looking to do this (Exhibit A).

Internal Analysis

Ethiopian's core competencies revolve around its ability to create value through its high-quality fleets and customer service. Its aircraft are among the most modern in the continent, whereas its African competitors struggle to maintain already-aged fleets. Ethiopian's aviation academy further distinguishes it as its trained workforce provides excellent customer service. In addition, despite Africa's positioning as the most unsafe place for flights, Ethiopian's promotion of safety highlights the quality of its service.

These factors have contributed to a strong reputation for quality and safety as well as distinct brand awareness, particularly in Middle and West Africa, where Ethiopian flies to multiple destinations. To maintain this reputation, the chosen hub location must be central to its existing network; this will allow it to continue operating short-haul flights in the segments of passenger transportation service, cargo freight, and services for other airlines.

As one of few successful state-owned airlines, Ethiopian has managed to turn an impressive profit of $14 million while the industry experienced an operating loss 8.5 times that amount. While a HS model provides greater value through more flights and destinations, Ethiopian will need to capitalize on its ability to create value in order to justify the additional coordination costs that will be passed on to customers through increased fares (Exhibit B).

Options

Determining where to locate the first new hub requires a three-tiered approach. Ethiopian must first determine the best African region to do this, followed by the most appropriate mode of entry, and the level of ownership (Exhibit C).

Ethiopian can pursue Northern, Middle, Western, or Southern Africa. Looking at the best region to enter, Middle Africa is the best option. Economically, this region has the highest GDP growth, indicating that the buying power of consumers will increase the most. It currently services six countries within this region, so it already has a certain level of brand awareness established among consumers. It is also the prime choice in terms of centrality which will help improve efficiency among its existing network while reaching a broader range of locations. With the highest regional air transport liberalizations score, Middle Africa has the least restrictive government regulations. Middle Africa's underdeveloped infrastructure is the ideal place for Ethiopian to leverage its core competencies, by offering high quality fleet, service, and safety. This will ultimately build this region's infrastructure and alleviate its lack of safe and reliable air transportation services (Exhibit D).

Ethiopian must then determine whether it is best to enter the Middle African market alone or through a joint venture. A joint venture is the best option because partnering with a major airline also requiring a hub in this region. Not only will it increase brand awareness, but it will also minimize the level of risk for both airlines since liability will be shared, as will the initial investment.

The last decision that Ethiopian must make is its level of ownership: minority ownership, 50% ownership, or majority ownership. Majority ownership is the best option since it is a state-owned airline, thus the government would require them to have majority control over operations. In addition to having the necessary resources to sustain that level of ownership, Ethiopian has the reputation which would appeal to another airline, especially since it offers qualities that are lacking in the Middle African region.

Recommendation

We recommend that Ethiopian's first new hub be located in Middle Africa via a joint venture with another airline looking to penetrate this region, and while maintaining majority ownership.

Implementation Plan

Short Term

Firstly, Ethiopian should focus on obtaining the IATA Operational Safety audit certificate to sustain its reputation as a safe flight provider.

Ethiopian must then determine the best partner for the joint venture, based on the following criteria: It must be an airline also looking to penetrate the Middle African region. Together, both companies can develop economies of scale, in order to increase efficiencies. This partner must also be financially stable, so that they will be capable of fulfilling the entire contract.

The deal will be compromised of 51% ownership for Ethiopian, and 49% for the partner. This will allow for the lowest possible risk, while maintaining control. To entice the partner to take a minority stake, Ethiopian will offer to pay up to 60% of the initial set up costs for this new hub. Together, both airlines will expand their reach in that region by increasing the number of routes and frequency of flights.

In order to be aware of all government regulations of any newly served destinations, Ethiopian should consult with the legal department of both parties in order to assure compliance and avoid any potential negative impact on each airline's business.

Medium Term

Initially, an airport should be sought out within the Middle African region in order to secure the space necessary to establish the hub, at an estimated cost of $200M for Ethiopian. The hub should allow for the accommodation of both airlines' capacities.

Then, with the assistance of the legal departments, routes should be further developed. All major cities in the Middle African region should be targeted.

In order to introduce these new routes, Ethiopian's current fleet of 35 airplanes must be adequately redistributed to cater to this new hub.

More staff will be needed to operate this new hub, particularly customer service staffs, pilots for the additional flights, and technicians for maintenance purposes. These new staff will be trained through Ethiopian's aviation academy in order to assure that its quality reputation is maintained.

To assure satisfactory utilization rates for all aircrafts, marketing to two target markets should be done. The first is local middle-class Africans in the Middle, and East regions to accommodate their intra-continental travel needs. The second is travellers coming to Africa for pleasure by accommodating their needs through flights to and from all major cities within the operating regions. When communicating with these segments, the messaging should be focused towards the quality of the planes, the staff, and overall service. As well, the IATA safety audit certification should be promoted since security is crucial to this geographic region. Finally, in order to encourage repeat bookings, a *frequent flyer* plan should be implemented.

Long Term

Ethiopian should build a partnership with a global aviation alliance. The benefit for the alliance would be increased access to Ethiopian's intra-African network, while being associated with Ethiopian's great reputation. In return, Ethiopian can gain access to the alliance's vast international networks, ultimately increasing fleet utilization and passenger traffic.

To continue growth, further expansions for a third hub should be evaluated within Africa. Also, evaluation of the effectiveness of the joint venture should be conducted, in order to determine if this is a suitable mode of entry for future business. Ethiopian should also consider expanding its fleet to sustain more growth, by focusing on the most modern and efficient aircrafts.

Finally, the continued growth should only be done after certain thresholds are obtained. These include:

- 70% passenger load factor;
- 80% of all possible routes in Middle and East Africa have been served;
- Reached 90% of capacity in current hubs;
- Mature top-line growth

Financial Implications

Opening a second hub will need a $264,000,000 initial investment. Low levels of retained earnings and cash on hand will require issuing debt and equity, despite a debt-to-equity ratio of 1.15. The state-owned nature of the business will however allow access to cheap capital, and ultimately the company to reach its goals of generating revenues of $1.1bn and flying 3.1M passengers by 2010 (Exhibits E-I).

Exhibits

Exhibit A: External Analysis

Political	Economic	Social/Demographics	Technological
• Government restrictions with Yamoussoukro Decision • Importance of IATA Safety Audit Certificate • Underdeveloped infrastructure	• Emerging middle class = increased buying power • High operational costs • Increasing economic growth • Africa is one of top aviation growth regions • Capital-intensive industry	• Increased ability to travel because of GDP growth • Intercontinental travel increasing 10.21 % • Africa makes up 3% of world air traffic • High accident rate reflects that safety is not a priority • Increasing number of LLC • Importance of alliances	• Advances in aviation technology

Force	Within African Airline Market	Degree of Threat
Threat of substitutes	For intra-continental travel: Buses, trains, automobiles.	Medium
Threat of new entrants	Very capital intensive industry, therefore few can afford to enter the industry. Big Players have economies of scale that are hard to match	Low
Rivalry among existing firms	High competition between current airlines for market share	High
Bargaining power of suppliers	Regulated by the government and manufacturers. (Fuel price, fleet price, etc)	Low
Bargaining power of buyers	High prices, so consumers switch to another airlines (LCC) or another mode of transportation	High

Exhibit B: Internal Analysis

Strengths	Weaknesses
• Diverse product lines (passenger flights, cargo shipments) • Strong reputation for safety gives credibility • High standards of training has created high quality staff	• Lack of economies of scale • Lack of after sales service

Firm Infrastructure	Human Resources	Procurement	Technology Development
•	• Aviation academy trains high-quality and skilled staff	•	• Modern, safe airplanes

In-bound Logistics	Operations	Out-bound Logistics	Marketing and Sales	Service
• Better planes • Well-trained staff • Airport infrastructure	• 35 aircrafts • Safety is important	• Wide network (49 destinations worldwide and 28 worldwide	• High quality customer service • High quality fleet and staff	• Offering after-flight service could be a key differentiator

Exhibit C: Decision Tree

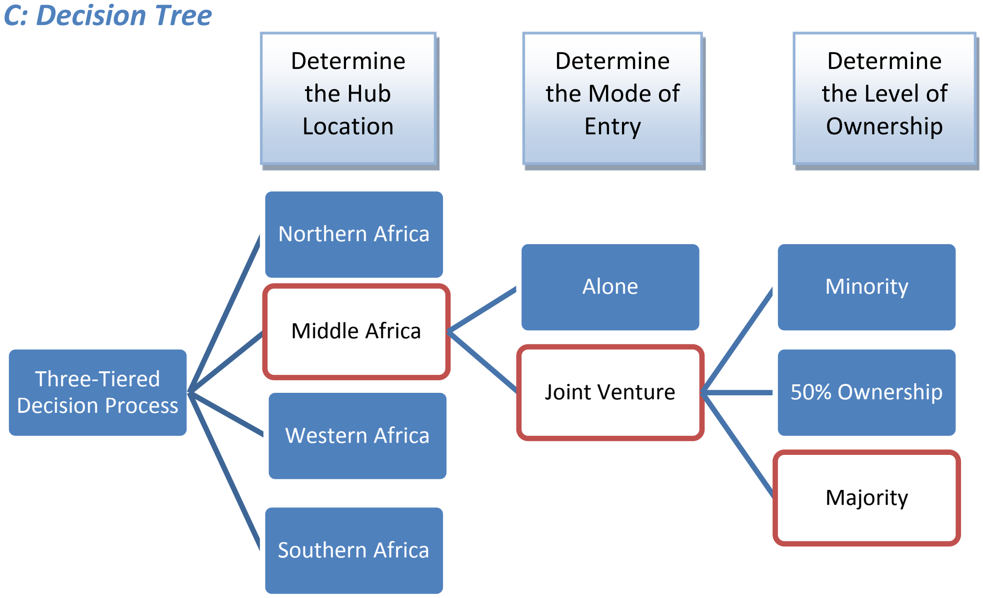


Exhibit D: Market Decision Criteria and Decision Matrix

Decision Criteria	Question
Economic Conditions	Does this market have a high GDP growth rate?
Population Growth Rate	Does this market have a high population growth rate?
Quality of Infrastructure	Does this market have an established high-quality infrastructure?
Uniformity of Population	Is this population culturally and linguistically uniform?
Current Presence in the Market	Does Ethiopian currently have a presence in this market?
Level of Competition	Is there a high level of competition in this market?
Brand Awareness	Does Ethiopian have brand awareness in this market?
Centrality	Does this region central to Ethiopian’s existing network?
Liberalization Score	Does this market have a high liberalization score?
Political Stability	Is this market politically stable?
Core Competencies	Does this market enable Ethiopian to fully capitalize its core competencies?

Exhibit D (cont'd): Market Decision Criteria and Decision Matrix

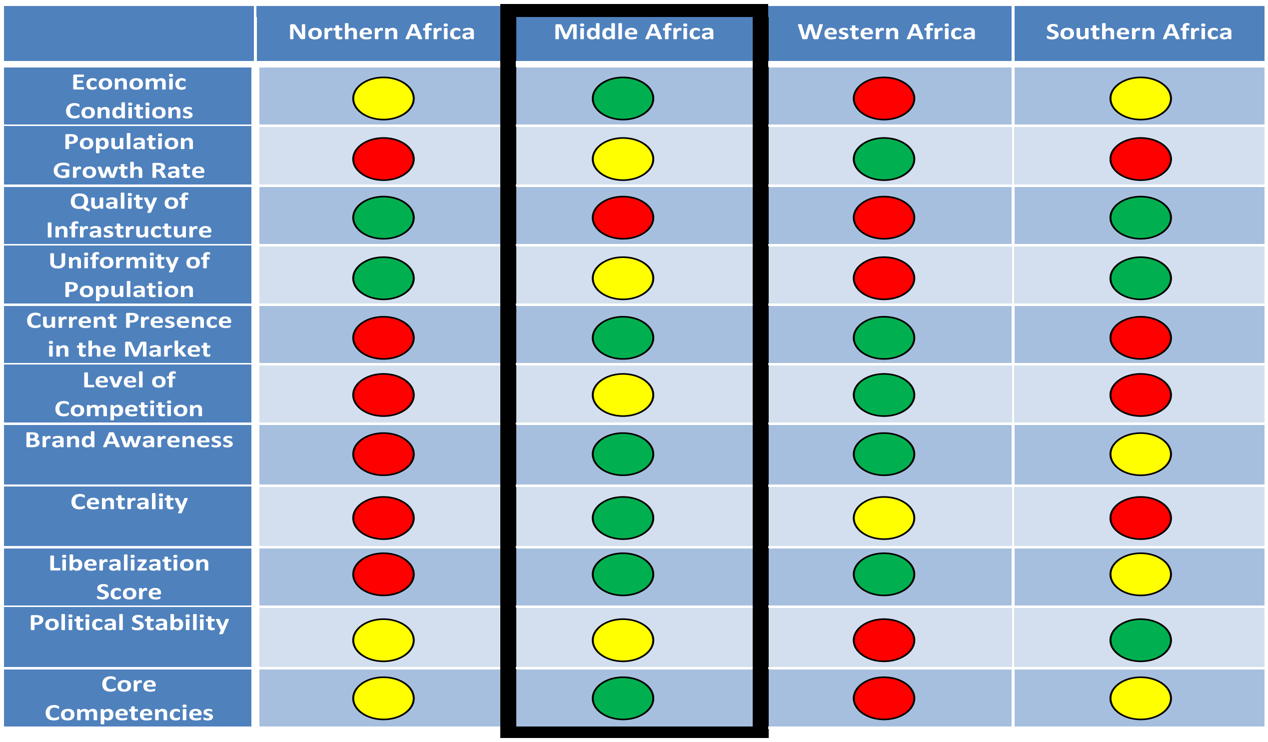


Exhibit E: Revenue Forecast

Revenues	2005	2006	2007	2008 E	2009 E	2010 E	2011 E
Average Ticket Price (ETB)	2,231	2,450	2,629	2,629	2,629	2,498	2,373
Average Ticket Price (US$) [1]	$245	$269	$289	$289	$289	$275	$261
% growth		*10%*	*7%*	*0%*	*0%*	*-5%*	*-5%*
Passenger Carried	1,552	1,763	2,096	2,410	2,651	3,049	3,354
% growth [2]		*14%*	*19%*	*15%*	*10%*	*15%*	*10%*
Passenger Revenues (80%) [3]	3,462	4,319	5,510	6,337	6,971	7,615	7,958
% growth		*25%*	*28%*	*15%*	*10%*	*9%*	*4%*
Total Revenues (EBT million)	4,328	5,399	6,888	7,921	8,713	9,519	9,948
Total Revenues ($ million)	$476	$594	$758	$871	$958	$1,047	$1,094
% growth		*25%*	*28%*	*15%*	*10%*	*9%*	*4%*

1 After stabilizing the average price ticket, Ethiopian will be able to reduce its average ticket price by -5% in 2010 and 2011 serving closer destinations

2 The number of passenger to increase at a 15% for 2010 and 2011 once the new hub will be operational

3 Ethiopian derive 80% of its revenues from flying passengers (20% from cargo and other services)

Ehtiopian will achieve its goal of $1bn of revenues and 3M passengers by 2010

Exhibit F: Profitability Forecast

Profitability	2005	2006	2007	2008 E	2009 E	2010 E	2011 E
Total Revenues (EBT)	4,328	5,399	6,888	7,921	8,713	9,519	9,948
COGS	3950	5162	6690	7,684	8,452	8,853	9,052
% growth		*31%*	*30%*	*15%*	*10%*	*5%*	*2%*
Fuel Costs	1,264	1,910	2,609	3,073	3,381	3,541	3,621
% of COGS [1]	*32%*	*37%*	*39%*	40%	40%	40%	40%
% growth		*51%*	*37%*	*18%*	*10%*	*5%*	*2%*
EBIT	378	237	198	238	261	666	895
Operating Margin [2]	9%	4%	3%	3%	3%	7%	9%
Profit	310	134	131	158	174	571	696
Profit Margin [2]	7%	2%	2%	2%	2%	6%	7%

1 We estimate fuel costs to remain at 40% of fuel costs in the future

2 Operating and profit margins will improve as the hub becomes operational and improves utilization rate

Exhibit G: Passenger Load Factor

Utilization	2005	2006	2007	2008 E	2009 E	2010 E	2011 E
Destination cities [1]	44	47	49	51	51	56	57
% growth		*7%*	*4%*	*4%*	*0%*	*10%*	*2%*
Available seat Km	7,473	8,973	11,357	13,239	14,298	14,130	13,663
% growth		*20%*	*27%*	*17%*	*8%*	*-1%*	*-3%*
Available seat Km/city [2]	170	191	232	260	280	252	240
% growth		*12%*	*21%*	*12%*	*8%*	*-10%*	*-5%*
Passenger Carried (000s)	1,552	1,763	2,096	2,410	2,651	3,049	3,354
Passenger seat Km (millions)	4,965	5,833	7,243	8,329	9,162	9,147	10,062
% growth		*17%*	*24%*	*15%*	*10%*	*0%*	*10%*
Km/passenger [3]	3,199	3,309	3,456	3,456	3,456	3,000	3,000
Passenger Load Factor	66.4%	65.0%	63.8%	62.9%	64.1%	64.7%	73.6%

1 The number of cities served will increase by 10% as the Hub will start serving new destinations

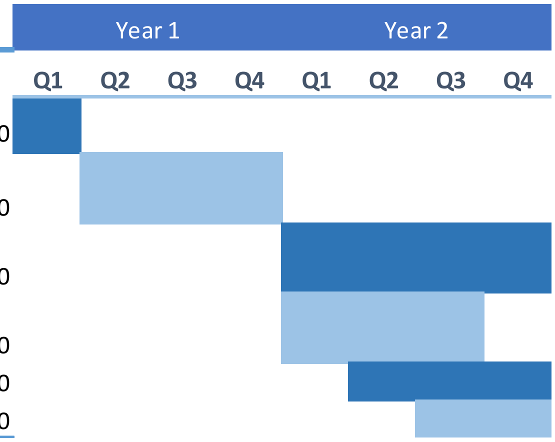
2 Available seat km per city will considerably decrease as Ethiopian will start serving closer destinations

3 Km/passenger will materially decrease as the new Hub will be operational

Ethiopian will reach its 70% passenger load factor threshold by 2011

Exhibit H: Implementation Cost and Timeline

Implementation Cost	
Structure Deal's term sheet with financial institutior	$2,000,000
Coordinate Airlines' legal departments for complian	$7,000,000
Assume 51% of Hub's expansion costs	$200,000,000
Elaborate new routes	$15,000,000
Hire and train new hub's staff	$10,000,000
Marketing Campaign	$30,000,000
New Hub expansion total cost	**$264,000,000**



*Project approved by government regulators and companies in 1 year

Exhibit I: Risks and Mitigations

Risk	Mitigations	Contingency
Hub's expansion partner does not agree to Ethiopian majority stake in the project	Propose to pay up to 60% of the project's total costs	Look for another partner
Passenger load factor doesn't reach the 70% threshold	Seek potential partnership with one of the major Airline Alliances	Partner with local and international travel agencies on promoting flight tickets
Can't identify partner for joint venture	Hire Investment bank to seek for potential partner	Screen for potential hubs available for rent
Local government refuse te proposed term sheet	Include needed modifications in the term sheet	Consider different hub's location