BUSINESS 478

Section D 100

STRATEGIC ANALYSIS FOR

LUFTHANSA

<u>GROUP D</u>

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HISTORY

The Deutsche Lufthansa AG traces its history to the 1920s, when it pioneered the aviation industry in Germany. Based in Cologne, Germany, the company has humble beginnings as it first began delivering airmail across Europe. Over the next 30 years, the company made great strides in improving the reliability, and timeliness of commercial flights by developing navigation techniques, and incorporating technological breakthroughs in airplane technology to increase the range of each flight. After the Second World War, the company began focusing on mass air transport.

In the 1960s, the jet engine powered airplane revolutionized air transport. The breakthrough allowed Lufthansa to achieve long distance flights with more passengers than ever before. The resulting decrease in airline rates allowed for an expansion of service around the globe and the company grew rapidly. By the end of the decade, the company offered flights to New York, Tokyo, and Johannesburg as well as many other international locations that were previously unimaginable[i].

The 1970s ushered in the era of commercialized air transport as the world knows it today. The first "jumbo" jets were introduced which allowed for cabins wide enough for two aisles and dispelled the old notion of confined air travel. However, the first major global challenges arose when two separate oil crisis' (1973, 1979) sent fuel prices skyrocketing and made profitability more difficult. The company, however, responded by having its engineers work with aircraft and engine manufacturers to improve fuel consumption of its air fleet.

The airline continued to grow throughout the next three decades. In 1997, Lufthansa became fully privatized[ii] and was a founding member of the Airline Alliance which included Air Canada, Scandinavian Airlines, Thai Airways, and United Airways. The alliance, being the first of its kind, brought cooperation to the industry among the largest airlines whilst allowing the members to take advantage of shared resources and a general marketing strategy for the industry. The company would continue to grow to become Europe's leading carrier and set the tone for innovation and advancement in a continually competitive industry.

In recent years, Lufthansa has encountered numerous struggles as the airline industry as a whole suffered several setbacks. The slowing economy and rising fuel prices led to a restructuring of the company in order to stay profitable. After incurring serious losses in 2012, the company cut about 20% of its workforce and rearranged its flight-hub network. Additionally, Lufthansa moved its short-haul operations outside its main Frankfurt and Munich hubs with its low-cost unit *Germanwings*. [iii]

Although it continues to face many challenges in an extremely competitive and volatile industry, Lufthansa is committed to continue striving for excellence as Europe's premier airline.

EXTERNAL ENVIRONMENT

Lufthansa group operates on a global scale, being the largest European airline in terms of revenue, scheduled passengers, fleet size and destinations; operating both in the passenger and cargo business. [iv] This scale makes the airline subject to a number of different markets, economies and cultures.

Demographic | As passenger carriage is a central and ubiquitous service in many parts of the world, one could assume that it is accessible to an almost unlimited client base. However, ticket prices are still only affordable for broader target groups in developed countries; in other regions, flying remains an option only for the wealthy.

Economic | One of the most provoking challenges for present-day airlines is their dependency on fuel prices. They are the main driver for the need for a state of the art fleet and can lead to oscillation in ticket prices. Other than that, the market entry of low-cost carriers has increased price erosion. These two contra-directional market forces and additionally generous pay for staff with older contracts leave only little margins for traditional airlines like Lufthansa.

Technological | Operating and maintaining a fleet of modern aircrafts requires a high degree of technological proficiency. The airliners themselves, as well as technologies, techniques and processes in the operation and maintenance are all subject to constant innovation. Not only is operating and flying the newest material possible paramount in order to retain a reputation as a top-tier carrier, it is also imperative in order to keep fuel costs as low as possible.

Sociodemographic | In the past few years, Lufthansa has made headlines for labour actions with both the aerial and the ground personnel involved. These resulted mainly from trying to switch staff to adjusted contracts with, for example, reduced pay. On the customer side, flying gains more and more acceptance as a means of transport even for shorter distances, especially since the alternatives (train, car) are increasingly less convenient and more expensive.

Legal | Most legal issues these days are connected with said labour disputes or lawsuits concerning passenger rights. However, some airlines have tried to realize efficiency gains by merging such as American Airlines and US Airways or Delta and Northwest in 2008. (Final approval of AA and US has been given in early November 2013). Lufthansa has experienced trouble with one of its newer subsidiaries, Austrian Airlines. When Austrian's staff refused to move to new payment schemes – Lufthansa transitioned Austrian's operations to Austrian's subsidiaries, Tyrolean, which resulted in the departure of a considerable number of employees. [v] Most recently, an Austrian court has retroactively ruled this transition void and thus added to the difficulties. [vi]

Porter's Five Forces

Threat of New Entrants
Low
High initial investments needed
Strong competition makes entry less appealing
Long approval process ("Red Tape")
Airports with few surplus capacities

Threat of Substitute of Products/Services
Moderate
No other way of traveling long distances
No other way of traveling so fast
BUT
Modern communications substitute some travels

INDUSTRY RIVALRY
HIGH

Bargaining Power of Buyers
High
- many airlines connecting the same destinations
- Low-Cost Carriers
- sinking real incomes in first world
- near-complete price transparency

Bargaining Power of Suppliers
High
Fuel prices not negotiable
Pressure to maintain a modern fleet

CURRENT SITUATION

Business Units

Lufthansa operates a number of airline subsidiaries: *SWISS*, *Austrian*, *Brussels Airlines*, *Germanwings*, *SunExpress*, *Edelweiss* and *JetBlue*. Altogether, the passenger airline group employed 55,236 individuals as of Dec 31, 2013.[vii]

As an airline operating on a global scale however, Lufthansa's operations cover more than just the carriage of passengers. Other ventures of Lufthansa Group include: *Lufthansa Cargo* (4,606 employees), *Lufthansa Technik*, responsible for maintenance and repair operations[1] (MRO, 20,282), *LSG Sky Chefs* (Catering, 30,088) and *Lufthansa Systems* (IT Services, 2,766), *Lufthansa Flight Training GmbH*, *Lufthansa AirPlus (*integrated solutions for business travel), *Lufthansa Consulting* and *Delvag Luftversicherungs-AG* (insurance services). *[See appendix 1: Corporate Structure]*

Fleet

By far the largest asset in Lufthansa Group's balance sheet is its fleet of aircraft. As of Dec 31, 2012, the group's fleet accounted for 627 aircraft with an average age of 11.2 years. [2]

In the constant endeavour to keep the fleet up to date and gain efficiency through the employment of larger airframes, Lufthansa saw the delivery of the first four Boeing 747-8i planes and two Airbus A380s in 2012. A total of 133 aircraft are on order for the period up to 2018.

Although not heavily reliant on leasing, Lufthansa Group keeps options for some leasing in order to be able to react to short-term changes in demand. [viii]

[See appendices 3f: Fleet and orders]

Business Level Strategy

Like most of their old competitors, Lufthansa started their operations with a differentiation strategy as flying was a good only for the wealthy and therefore the price was of minor importance. Nowadays,

[1] Note that Lufthansa Technik is also catering to external customers. (Source: Lufthansa)
[2] 479 aircraft are to be considered short- and medium-haul, 148 long-haul.

due to the pricing erosion by low cost carriers and the superior service and newer aircrafts of Middle East and Asian carriers Lufthansa has given up their pure differentiation strategy and can be considered as operating with an integrated low-cost/differentiation strategy. This mainly derives from the fact that they still operate as Europe´s premium carrier, however, they gave part of their operations to their low-cost subsidiary *Germanwings*.

Competitors

The competitive field in the airline industry can be divided in two different groups. On the one hand low-cost carrier that mainly operate on short and middle distance flights, and large international carriers that operate transcontinental and as well on short and middle distance routes. Lufthansa being part of the latter suffers from pricing erosion on intra-European flights from carriers like *Ryanair*, *EasyJet* and *Norwegian Airlines*. On long distance flights especially towards Asia Asian carriers like *Singapore Airlines* and Middle East carriers like *Emirates*, *Etihad* and *Qatar Airways* beat Lufthansa with superior service and newer aircrafts. [3] Other large European carriers like *British Airways* and *Air France*/*KLM* face the same challenges as Lufthansa due to similar operations and strategies; however, so far Lufthansa has been able to outperform them.[ix] [x]

Financial Situation

In the fiscal year of 2012, Lufthansa generated revenues of € 30.135 bn. The passenger airline group earned the majority of the revenue with sales of € 23,559 bn. MRO (€ 4.013 bn), Logistics (€ 2.688 bn), LSG Sky Chefs (€ 2.503 bn) and Lufthansa systems (€ 609 m) make up for the rest of the revenue. With an adjusted operating margin of 8.6% MRO was the most profitable part of the Lufthansa group. The main revenue generator, the passenger airline group, only had an adjusted operating margin of 1.6%.[xi]

[See appendix 4: Revenue and adjusted operating margin]

[3] "The Gulf Three" have in fact placed orders for approx. 400 latest-generation airframes from Airbus and Boeing on Nov 17, day one of this year's Dubai Airshow. Combined, these orders account for $ 196bn. More orders are being announced as the final touches are put on this report.

MAIN STRATEGIC CHALLENGES

1. Rising competition from Middle East carriers

Especially on routes from Europe to Asia, competitors from the Middle East like *Emirates*, *Etihad* and *Qatar Airways* fight Lufthansa with cheaper prices and superior service. These airlines are highly subsidized by local governments, have access to cheap kerosene and operate with a young and efficient fleet.

2. Rising operating expenses due to fuel price

In 2001 Lufthansa spent around € 1,621m on fuel for their aircrafts. Due to rising oil prices and an increasing fleet the company spent € 5,128m on fuel in 2010. [xii] This trend is not only a substantial threat for the Lufthansa group but for the airline industry as a whole. It forces the carriers to renew their fleet on a regular basis to keep up with the competitors and to be able offer competitive prices. Today´s aircrafts are around 70% more fuel efficient than the ones 40 years ago and still 20% better than a new aircraft 10 years ago. The new A380 for instance consumes only around three litres per passenger per 100 km. [xiii]

3. Environmental restrictions

Especially the European Union has set up many goals to reduce the overall CO_2 emissions. One of them is to reduce the emissions from flights to around 85% of 2010 emissions for each airline. [xiv] Additionally the EU started to charge a fee per ton of CO_2 emitted per flight. Being based in Germany, those regulations have a major impact on Lufthansa's short and middle distance flights.

4. Price war on European flights

Mainly due to low cost carriers like *Ryanair*, *EasyJet* and *Norwegian Air* the prices for intra-European flights dropped dramatically. People got used to flying as a cheap a fast substitute for the train or car even on short distances. Lufthansa is not able to offer the same low prices due to a more expensive cost structure with regards to personnel expenses and airport fees.

5. Stuck in the middle

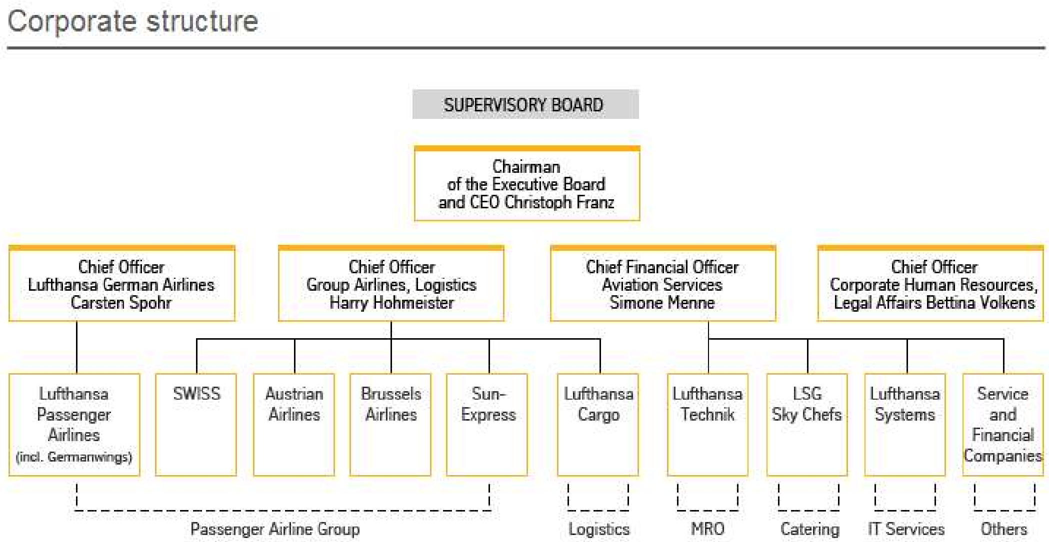
In the current situation, Lufthansa struggles to clearly state which customers they intend to serve and what quality standards to offer. On the one hand they try to fight the low cost carrier competitors with reduced prices on intra-European flights. On the other hand they still try to differentiate from these competitors by offering superior service and operating from centrally located airports. The same picture can be painted on long distance flights. The highly subsidized airlines from the Middle East beat Lufthansa´s prices and at the same time Asian airlines like Singapore Airlines offer superior service.

6. Remain profitability

In 2010 Lufthansa generated revenue of € 27.324bn and had a net profit of € 1.131bn. [xv] This equals a return on sales of only 3.6%. By looking at the 2009 numbers it becomes clear that profit is highly volatile. In 2009 Lufthansa generated a loss of € 34m. The large fluctuations in profit make long term decisions like investments in new aircrafts more difficult and risky.

APPENDIX

1: Corporate Structure



xvi

2: Group Fleet

Group fleet – Number of commercial aircraft and fleet orders
Deutsche Lufthansa AG (LH), SWISS (LX), Austrian Airlines (OS), Germanwings (4U), Lufthansa CityLine (CLH), Air Dolomiti (EN), Eurowings (EW) and Lufthansa Cargo (LCAG) as of 31.12.2012

Manufacturer/type	LH	LX	OS	4U	CLH	EN	EW	LCAG	Group fleet	of which finance lease	of which operating lease	Change compared with 31.12.11	Additions 2013 to 2018	Additional options
Airbus A310	2[3]								2			–		
Airbus A319	35	7	7	32					81	2	16	−6	7	
Airbus A320	49	27	13						89	15	2	+2	53	
Airbus A321	62	7	6						75	4		−1	9	5
Airbus A330	18	18							36		4	+2	3	2
Airbus A340	48	13	2[2]						63	2	2	−2		
Airbus A380	10								10			+2	7	3
Boeing 737	40		5						45			−35		
Boeing 747	29								29			−1	15	
Boeing 767			6						6	2		–		
Boeing 777			4						4			–	5	5
Boeing MD-11F								18	18			–		
Bombardier CRJ	23[1]				32		1		56		1	−9		
Bombardier C-Series									0			–	30	30
Bombardier Q-Series			14						14			–		
ATR	5[1]					6			11		6	–		
Avro RJ		20			2				22		6	−7		
Embraer	39[1]		3[3]						42	2		−14	4	
Fokker F70			9						9			–		
Fokker F100			15						15			–		
Total aircraft	**360**	**92**	**84**	**32**	**34**	**6**	**1**	**18**	**627**	**27**	**37**	**−69**	**133**	**45**

[1] Let to Lufthansa regional airlines.
[2] Let to SWISS.
[3] Leased to company outside the Group.

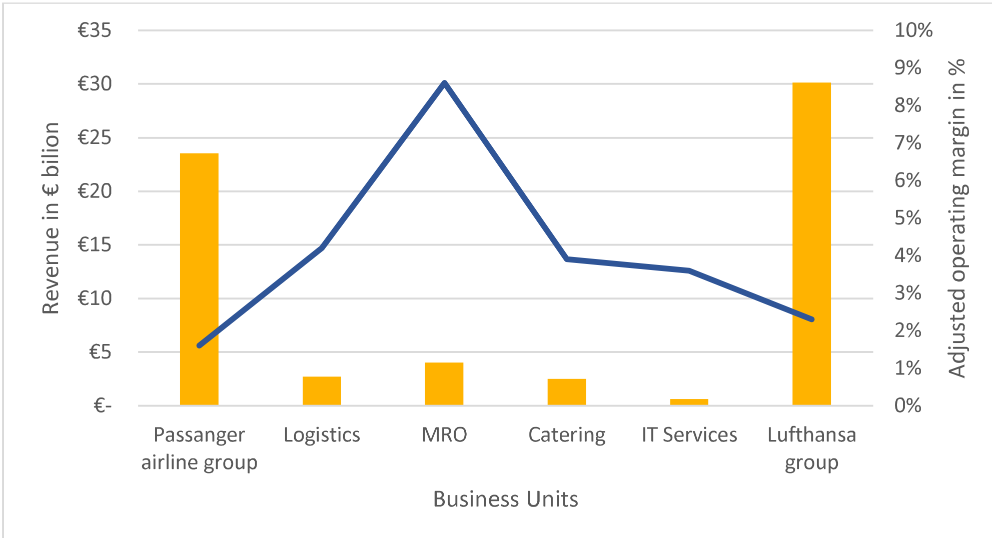
3: Fleet Orders

Fleet orders

		Deliveries
Long-haul fleet		
7	Airbus A380	2014 to 2015
15	Boeing 747-8i	2013 to 2015
5	Boeing 777F	2013 to 2015
1	Airbus A330	2014
2	Airbus A330	2013 to 2016
Short-haul fleet		
57	Airbus A320 family	2013 to 2018
6	Airbus A320 family	2013 to 2014
3	Airbus A320 family	2013 to 2016
3	Airbus A320 family	2013
Regional fleet		
30	Bombardier C-Series	2014 to 2016
4	Embraer EMB190 family	2013

xvii

4: Revenues and adjusted operating margin



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[i] http://www.lufthansagroup.com/en/company/history.html
[ii] http://www.lufthansagroup.com/unternehmen/geschichte/1990er-jahre.html
[iii] http://www.bloomberg.com/news/2012-09-19/lufthansa-to-combine-european-flights-into-low-cost-unit.html
[iv] http://investor-relations.lufthansagroup.com/en/finanzberichte/traffic-figures.html
[v] http://derstandard.at/1334795680100/Betriebsuebergang-fixiert-Einzelvertraege-oder-Abgang-fuer-AUA-Bordcrew
[vi] http://wirtschaftsblatt.at/home/nachrichten/oesterreich/1447900/AUABetriebsubergang-auf-Tyrolean-laut-Richter-nichtig
[vii] http://investor-relations.lufthansagroup.com/en/fakten-zum-unternehmen/key-data/business-segments.html
[viii] http://www.delvag.de/cms/content/index.html?__locale=en Lufthansa Annual Report 2012, p. 56f
[ix]
http://reports.lufthansa.com/2011/ar/combinedmanagementreport/businesssegmentperformance/passengerairlinegroup/marketsandcompetition.html
[x] http://www.khaleejtimes.com/kt-article-display-1.asp?xfile=data/dubaiairshow/2013/November/dubaiairshow_November11.xml&section=dubaiairshow
[xi] http://investor-relations.lufthansagroup.com/en/fakten-zum-unternehmen/key-data/business-segments.html
[xii] http://reports.lufthansa.com/2010/ar/servicepages/keyfigurescomparison.html?cat=t#/table/8/0,1,2,3,4,5,6,7,8,9/figures/0
[xiii] http://www.iata.org/whatwedo/ops-infra/Pages/fuel-efficiency.aspx
[xiv] http://www.fas.org/sgp/crs/row/R42392.pdf
[xv]
http://reports.lufthansa.com/2010/ar/servicepages/keyfigurescomparison.html?cat=t#/table/1,2,4,5/0,1,2,3,4,5,6,7,8,9/figures/0
[xvi] http://investor-relations.lufthansagroup.com/en/fakten-zum-unternehmen/corporate-structure.html#a-top
[xvii] http://investor-relations.lufthansagroup.com/fileadmin/downloads/en/financial-reports/annual-reports/LH-AR-2012-e.pdf#page=60