

Sky Airline: Business Model Transformation and Future Challenges

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Our leitmotiv is to democratize air travel...to enable more and more people to fly.

Holger Paulmann¹

Watch the costs and the profits will take care of themselves.

Andrew Carnegie²

Introduction

On August 20, 2018, Holger Paulmann, CEO of Sky Airline (Sky), summoned his executive team to a strategy review meeting to discuss the company's answer to the recently announced purchase of 76 new Airbus 320 Family aircraft by Jet Smart, one of Sky's competitors, in a deal valued at US\$8.4 billion. Airbus was set to deliver the airplanes between 2018 and 2026.³

Sky Airline—Chile's second-largest airline behind rival LATAM Airlines (LATAM)—had just finished a successful transformation of its business model in the first quarter of 2017 and was already facing new challenges. In addition to Jet Smart, other low-cost carriers were entering

¹ Interview with case authors, November 24, 2017, Sky Airline HQ, Santiago, Chile.

² Paul S. Boyer et al., *The Enduring Vision: A History of the American People* (Boston: Wadsworth, Cengage Learning, 2011), 539.

³ Reuters, "Acciones europeas se disparan por anuncio de la Fed," *Economía y Negocios*, accessed August 28, 2018, <http://www.economiaynegocios.cl/noticias/noticias.asp?id=43417>.

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the South American market and, according to some press releases, the giant LATAM had initiated feasibility studies for starting up a low-cost airline.⁴

Sky served international routes from Chile to Argentina, Brazil, Peru and Uruguay, and in August 2018 it announced the start of domestic flights in Peru. Holger's father, Jürgen Paulmann, founded the company in 2001 as a traditional full-service carrier (FSC). In 2015, under Holger's leadership, Sky began its transformation into a low-cost carrier business model (LCC). The LCC model was grounded on a basic fare—to which passengers had the choice of adding services from a pool of options for an additional fee—and a simpler, more efficient revenue management system. This “unbundled” fare lowered the company's sales costs, made online tickets the norm through the adoption of new technology, and boosted brand recognition and customer satisfaction to new highs. In an aggressive drive for profitability, in 2016 and 2017 Sky added 11 new destinations to its route map (see **Exhibit 1**).

Jet Smart, launched by the US investment fund Indigo Partners in July 2017, was an ultra-low-cost carrier (ULCC) based in Santiago, Chile. It operated three Airbus A320neos but was transitioning its fleet to the new A320neo. Though it was only flying routes in Chile at the time, the airline was said to have the goal of leading the South American market.⁵ Concurrently, other airlines, such as Flybondi.com and Norwegian Air in Argentina, Wingo in Colombia and Viva Air in Peru, had started operations with the ULCC business model.

At the strategy review meeting, Holger wanted to hear what the airline's executive team had to say about the South American competitive landscape. He expected Sky Chief Marketing Officer Carmen Gloria Serrat to provide the team with insights about demand growth and Sky Chief Financial Officer José Ignacio Dougnac to voice his opinion about the financial prospects, as a new expansion of Sky's fleet would involve contracts amounting to billions of dollars.

The Early Years: 2001-2014

Jürgen Paulmann, a Chilean entrepreneur founded Sky Airline in 2001. As with most start-ups, the story behind Sky involved some serendipity.

Paulmann owned a range of companies in real estate, food distribution, supermarkets, forestry and agriculture. His management style was simple: he was the CEO of all his companies with support from a small group of subordinates. He launched new ventures in a frugal and disciplined manner and mostly succeeded, but the challenge of starting up an airline was daunting, especially since Sky Airline began its operations in Cuba.

In 2001, Paulmann was exporting food from Chile to Cuba through one of his companies, when a contact in Havana told him about an opportunity to start an airline on the island. After signing a “wet lease”⁶ contract with the Cuban tourism agency, Paulmann launched the airline with one Boeing 737-200 under the Sky Airline brand and palm trees in the logo.⁷ However, the US

⁴ *El Mercurio*, April 14, 2018.

⁵ “DGAC otorga autorización a línea aérea JetSmart para iniciar operaciones en Chile,” *La Tercera*, June 23, 2017.

⁶ “Wet lease: A leasing arrangement whereby one airline provides an aircraft, complete crew, maintenance, and insurance to another airline or other type of business acting as a broker of air travel, which pays by hours operated. Retrieved from: “Aircraft lease,” Wikipedia, The Free Encyclopedia, accessed December 5, 2017, https://en.wikipedia.org/w/index.php?title=Aircraft_lease&oldid=879766012.

⁷ The name was later changed to Sky Airline.



embargo on Cuba was tightly in place, so Jürgen had to shut down the airline's operations due to lack of spare parts for maintenance.

Paulmann tried again shortly after, this time launching Sky Airline in Chile. The Chilean aeronautic authority (DGAC) had cancelled the license held by Aero Continente, a Peruvian airline operating in Chile, due to drug trafficking charges by the DEA. At the time, Lan Chile Airlines (LATAM's predecessor) held 85% of the market, and Aero Continente had the rest. Paulmann decided to challenge LAN's hegemony by taking advantage of the vacuum left by Aero Continente.

By mid-2002, Sky was in the air with three leased 737-200 aircraft (seating 120 passengers) under a full-service model. Over the next decade, Sky's fleet grew by 12 additional Boeing 737-200 aircraft to reach 15 planes by 2014. At the time, LAN was replacing its Boeing 737-200s with the larger, more efficient Airbus A319 and A320 aircraft and was expanding both its domestic and international networks. Taking advantage of LAN's discarded planes, Paulmann was able to increase his fleet of 737-200s with the aircraft that LAN was dismissing. However, the low fuel efficiency and high maintenance costs of the more than 30-year-old airplanes were not offset by the low leasing cost. When the airline moved into the international market with two flights per week to Lima, Peru in 2010, the new route proved to be a drain on profitability because of the low fuel efficiency of the airplanes, the restricted passenger schedules and the higher maintenance costs of Sky's fleet.

Although the company made some inroads in the market, Sky Airline was unable to break even until 2007. From 2008 to 2014, the company showed mixed financial results; its market share peaked in 2013 with about 15% of the Chilean domestic market. Profitability was difficult to achieve as load factors⁸ were low. Paulmann tried to improve results by scheduling multi-stop itineraries, but the low fuel efficiency of his planes, the downtimes, the poorly designed processes run on outdated IT systems and weak marketing programs conspired against his efforts. At the time, Sky lacked a revenue management system and a loyalty program, both of which LAN had pioneered in Latin America.

Competition: 2002 – 2014

During this period, LAN was the main player in the Chilean domestic air market. A leading airline in Latin America and the main air cargo operator in the region, LAN had a dual business model: combining passenger and cargo. This created significant synergies, as LAN moved shipments in the belly of its passenger planes as well as with its fleet of cargo planes in Chile, Brazil, Colombia and Mexico. In the Chilean domestic market, LAN's network was much denser than Sky's, covering more cities and with higher frequency than Sky.

In 2007, LAN launched a strategy to stimulate demand for air travel on its short-haul flights (typically domestic flights) by offering lower-fare options to travelers—bringing fares down by 20% on average—to induce high aircraft utilization and increase operational efficiencies. The assumption behind this strategy change was that demand for short-haul routes would prove to be more price sensitive than demand for long-haul routes. A hot meal and other ancillary services such as luggage transfers were more important for long-haul travelers than for short-haul passengers. As such, LAN continued to operate as a full-service airline in the international long-haul passenger business while moving towards a business model with some low-cost

⁸ Load factor: the ratio of passengers carried in a flight to the maximum possible capacity.