

HAMBURG AVIATION CONFERENCE 2015
“THINK FUTURE”

**INNOVATION IS NOT A CHOICE - Changes in business practices mean that innovation
has become both a way of life and necessary for survival**

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A changing world

We are on the threshold of a period of very major change around the world – which will reshape the interaction between people, markets (including business) and governments. It is a new industrial revolution. This very major change is occurring across all of life and is both a state of mind and an environment. Much of what is happening is a reflection of changing personal attitudes, development of social media, and greater financial volatility. The world is changing faster and more fundamentally than many thought possible or anyone really expected.

This is an exciting phase for the world, and for any industry, and is a perfect time for meaningful innovation, which should work in tandem with change. This should be regarded as the new norm. However, it is also competitive – so the businesses and leadership teams that embrace innovation most effectively will win, and others who do not will fall behind. But, the competition for best innovation should not create more risk.

This “Innovation Game” is the stepping off point for the next 5 years and has a parallel with 2010 where in the UK travel sector there was a “Technology Race”, and now it is all about utilisation of that technology.

The winner of the Innovation Game will be the group that uses it best and the one which thinks about its broader impact beyond simply technological advance. How innovation meets the way people wish to behave lies at the heart of the opportunity – and not the other way round. It is people and behaviour that are the driver of innovation (what does the customer want?); where technology offers a new behaviour then investment is also needed in education and acceptance.

The theme of “very major change” will impact all businesses of all sizes. It will tend to favour newer, smaller businesses - which by virtue of their size or character are those more capable of fast adaptation. It is a fact that businesses with their DNA buried deeply in their history will find change and adaptation more problematic.

In some industries where size is a pre-requisite for successful competition, companies will need to adapt in spite of their size, resulting in a high stakes game between major players, and unavoidable greater pressures being heaped on management. Commercial aviation is a sector where size is, broadly speaking, a pre-requisite for successful competition, where positive profit margins are made up of microscopic numbers multiplied millions of times. In

airlines, size also matters in the race for competitive unit costs, for cost effective investment in brand and customer loyalty, and in favourable capital investment decisions. Smaller players are fortunate if circumstances favour them, and if so they are exceptions. There is room in certain circumstances for smaller specialist players.

This environment in airlines will inevitably stoke the forces of consolidation, which is inevitable and desirable – these forces will continue to bear upon the industry, and the weaker players in particular, until a group of efficient players cohabit and compete in something like equilibrium, with a few specialist players succeeding alongside them. This is an ambitious goal in one of the most complex and competitive industries in the world, with a safety imperative and with long investment horizons and generally narrow and cyclical short term profit margins. However, innovation will translate into points in the game and will select the winners - both large and specialists. The winner of the Innovation Game will decide who is the consolidator, and who will be consolidated. The future shape of the airline sector will then influence the competitive success of their partners, and the airports in particular.

With development of social media, values become important, number of large complex businesses will reduce

In the 1980s our professional lives were defined by our physical surroundings, which at many different levels including the subconscious created loyalty, underscored motivation, and contributed to a sense of long term engagement with the organisation. We expected to stay in these positions for life. There was also a clear separation between time spent at work and at home.

Now, through new technology people can communicate, unmonitored, uncontrolled, with the world. Technology has become empowerment, and it is immediate. It is also a responsibility. Social media has brought about a change in attitudes in personnel that impacts the foundations of organisations themselves. The immediacy and widespread nature of social media communication has disintermediated the power of people who think they are in power – we see this in the progressively weakening grip of established political parties, or the media, or of business organisations over their employees.

With the dismantling of physical constraints around an organisation, the motivation and cohesion of teams now depend on values – the “what do we stand for” issues around the organisation. These values are those set and lived out by the leadership – they are the binding agents of the organisations of the future - they need to be seen on the face of the CEO, and the whole of the leadership structure. It is not enough to have appealing words in the lobby.

In businesses, in order to maintain cohesion, senior management will need to be able transmit credible value systems successfully across large organisations. The employee says, “I do not work any longer because of the physical surroundings I am in. I work because I am loyal to

the organisation. And I am loyal to the organisation because it represents something important to me.”

This is a message employees need to hear from the leadership – whose communication skills will need to be greater and more multi-disciplined than ever before. This is demanding and authenticity is key - it is likely that fewer individuals will be able to meet this challenge, and the number of large successful multi-activity organisations around the world will reduce, and more focused businesses of whatever size will sit in their place.

Changing personal attitudes, empowerment, reaction to values, examples

The empowerment of individuals through social media is irreversible. The sense of empowerment is already translating into new abilities of self expression. It is a leveller. But we have not yet seen the full scope of what previously silent communities could do with their ability to express their views and act together.

Some companies are meeting and embracing empowerment head on in revised and innovative corporate cultures – where, to take one example, Netflix employees are now empowered through broad terms of employment much of which are self-selected, including how much holiday they take.

With an empowered workforce, the values adopted by an organisation cannot be vaneer. Employees will look hard into the faces of leadership and share with each other what they see. The audience is critical and intolerant. In consumer facing businesses, the customer does the same thing.

Values which resonate well with the employee and customer audiences are authenticity, interest in “value” not “money”, and “servant leadership” in the true sense, and whether the leadership supports empowerment, with sharing responsibility, and facilitates it with resources. Negative judgements will be applied to management who are interested only in themselves, shareholders who are interested only in money, short term window dressing and vaneer. For leaders and recruitment of leadership teams, every action tells your audience what you value, and exceptional performance should not be rewarded until it is known exactly how it has been achieved.

Greater financial volatility, and the risks of innovation

There is a more volatile financial outlook. It is interesting to note that the innovation in technology and business structures in the financial sector over the last 20 years has created substantially more risk than the global financial system ever faced before. And the aviation sector does not live in isolation.

In global finance there are large blocks of capital chasing single opportunities, and traditional forces of money supply have been distorted by central banks creating money in very large quantities for short term “risk management” reasons; and long term markets (bonds,

equities) are functioning increasingly without solid valuation fundamentals - with very large risks including deflation, high levels of private debt, and a distressed savings industry on the horizon.

This results in volatility in currency and fuel costs, gyrations in equity values and borrowing costs – which will make investment decisions across the industry (which are necessarily long term) highly problematic. Major aviation groups now also have capital trapped in margin calls for fuel and currency that could otherwise be deployed in taking advantage of this volatility.

Aviation industry at a crossroads

The challenge is to try to match the period of fundamental change with a burst of innovation – and increase the industry’s financial and operational resilience accordingly. For the first time in 5 years, the fuel price is working in its favour - until recently representing about one third of unit costs, this has now fallen to about a fifth for those able to take advantage of it. But the industry needs as a whole to continue to consolidate to bring equilibrium to the market, strengthen its customer proposition, improve profit margins and reduce cyclicity. The recent improvement in oil price does not provide anything other than short term relief and an opportunity to consolidate with reduced threat to employees and pensions.

The US market has already been through its consolidation phase and achieves better margins and capacity discipline. 80% of US capacity is controlled by 4 carriers. Capacity is down 6% since 2006, and return on capital employed has risen. There are already developments on this within Europe – and also outside Europe - but the industry should not delay its consolidation momentum. Where European consolidation remains unfinished in both specialist shorthaul flying, and in long haul which now actively involves the Middle East carriers (and it is only a matter of time before it involves Far East players particularly Indian and Chinese), it is also only a matter of time before competition policy for European Governments will be tested in the process – itself the subject of potential innovation - as will the concept of nationality which is still important to many European states.

Innovation is the new norm

Innovation need not be limited to technological advances and customer service. It will come in finance – for example, innovations are being developed in financial instruments which are now being introduced, which are designed to release capital back into the industry to provide much needed resilience in the next fuel upcycle and financial downcycle. Innovations in e-commerce, loyalty and insurance solutions to release credit card collateral all offer scope for improvements in cashflow and unlocking of working capital. And it will come in new types of partnerships – where commercial agreements rather than ownership could be a new format for consolidation, and where new types of relationships emerge including for example opening up the vast opportunity for airports to enter new formats of relationships with airlines and customers themselves.

Competitive opportunity

Organisations who embrace innovation can produce results which are lastingly good, not only in financial terms, but also in outcomes for people, the industry and the fabric of society. Money outcomes alone are not sufficient for the generation of employees, management and customers to come.

Innovation and risk

Innovation must be set in the context of the broader purpose of the enterprise and should not create risk, whether in pilot training or employment conditions, where for example BALPA have recently written in the FT saying their recent launch of an app for young union members was intended to support young pilots with a sense of community, and assist supporting and maintaining a safety culture.

The “Innovation Conundrum”

Looking again at where innovation in the financial sector has taken us presents a conundrum. Since the financial crisis, that sector has created a level of risk over 5 years that has become so systemic that it can only be managed by creating more risk, at least for the time being. Why is this? The decision-makers are concerned that the system that has been created cannot bear the weight of the change which is actually necessary - and they have lost sight of the core rationale for money and the financial system - which is to facilitate humanity's striving to improve itself.

The institutions having responsibility and jurisdiction for this risk are hoping for something else to arrive in the meantime which can address it. The human race is actually quite good at adaptation and finding solutions in every sphere. But for a time (we do not know how long, and who will suffer in the meantime) the global financial risk has reached profoundly uncomfortable levels, with existing policy and implementation based around flawed reasoning.

Conclusions and the aviation industry

In an industry which has at its heart a safety imperative, creating this type of environment in aviation would be unacceptable - as would losing sight of the industry rationale including the principle that, “After safety, the customer comes first.”

Aviation is one of the best pre-emptive risk managers in the world today. Its standards are high and it is used to striving for excellence. We work towards making sure the aviation industry of tomorrow is more effective, resilient and even safer than it is today. While the need for change is ever pressing, the conditions for effecting change through innovation have seldom been more favourable.

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