

Swissair: Crashed and Burned

The collapse of Swissair illustrates that even a company with – on the face of it – a board of strong non-executive directors with outstanding personal track records, can get things wrong. It is a story of poor strategic decisions, a failure to properly assess risk and the dangers of over-reliance on external consultants. It also shows that even a renowned brand is not invulnerable.

Switzerland was stunned, shocked and outraged when, on 2 October 2001, Swissair, a national icon and source of pride, grounded its fleet, unable to afford to keep its planes in the air. The company had been struggling under a huge debt burden in the economic downturn which had impacted the entire airline industry. The terrorist attacks in New York on 11 September 2001 were the last straw, having a disastrous and immediate effect on the company's liquidity as passenger numbers plummeted. Swissair was grievously wounded, and when it went into receivership shortly afterwards, banks and bondholders were left with claims of over SFr 6 billion.

All of Switzerland wanted to know how this could have happened to a company that was overseen by a board comprised of the great and good of Swiss industry, commerce and finance.

Swissair takes off

Formed in 1931 by the merger of two regional Swiss airlines and listed on the Zurich stock exchange in 1947, Swissair grew from an operating base of just 13 aircraft and 64 employees to establish itself as a quality global airline, albeit small in comparison with the likes of Lufthansa and British Airways (BA). And this was despite the limitations of a small domestic market – in terms of both population and geographical size – which was already extremely well served by rail and road transport.

Capitalising on the Swiss reputation for precision timing and reliability, Swissair became synonymous with first-class service, winning numerous travel awards in the process. Also a reflection of Swiss culture and its diversity, although with a less positive effect, was a seemingly constant battle between Zurich and Geneva to gain the status of Swissair's main hub. Zurich eventually won the war, much to the disgruntlement of the French-speaking population.

Airline industry deregulation in Europe

Until 1987, European airlines were largely state-owned and controlled. They enjoyed high levels of subsidy and protectionism to prevent them – as largely loss-making enterprises – from going under. Most were highly integrated, including a whole range of airline-related activities. Many were subject to high levels of unionisation, which gave rise to frequent strikes. Switzerland was the exception.

Airlines tended to dominate departure and arrival slots at their designated national hubs and often had a monopoly on services, such as in-flight catering, baggage handling and check-in facilities, provided to other airlines. By negotiation between the respective governments, bilateral reciprocal agreements were reached for airlines to operate out of foreign hubs.

In 1987 the European Commission introduced a three-phase ten-year reform of the industry, ultimately enabling European Union airlines to operate on any route in the EU, including flights wholly within another country. By January 1993, the international skies across the EU were effectively already open to any EU airline.

A new breed of airline rose out of the newly liberalised environment, and competition intensified as low-cost carriers such as Ryanair, easyJet and Virgin Express successfully set up shop. With national flag carriers still dominating the main hubs, and the allocation of slots a hotly disputed issue at times, access to airports became more important. Swissair was forced to watch from the sidelines of the EU and to continue negotiating bilateral agreements with the individual governments.

An alliance is proposed

In 1989 Swissair had joined forces with the US carrier Delta and Singapore Airlines in what was known as the Global Excellence Network (GEN). The aim was to provide a truly global alliance, offering an

unparalleled level of service and number of flights. However, in light of the Swiss 'no' vote on EU membership in 1992, Delta and Singapore began to question the contribution of their European partner to the alliance. The pressure was mounting on Swissair to find a way to break into the EU.

Alcazar was to be the solution. In April 1993, Scandinavian Airline Systems (SAS), KLM Royal Dutch Airlines, Swissair and Austrian Airlines announced plans to set up a joint venture company, Alcazar, under which the four airlines would merge their respective operations. This would enable them to compete with the major European players and ultimately even the US 'mega carriers'. Alcazar's prospects were sufficiently strong that the Lufthansa CEO at the time, Jurgen Weber, openly admitted that the outlook for Lufthansa was bleak in the face of such competition.

It was too good to be true – Alcazar never made it off the runway. In what was a significant turning point for Swissair, negotiations faltered and were eventually abandoned at the end of 1993. The stumbling block was the existing alliances between the partner airlines and their respective US partners. Politics and egos clashed as neither KLM nor Swissair wanted to relinquish its existing US partnership in favour of one which would require it to fly via another European hub. In particular, KLM wanted to build on its Northwest Airlines shareholding, whereas the other airlines favoured Swissair's partner, Delta, which was thought to be more financially sound and to have a more comprehensive US network. Furthermore, popular support for the Alcazar project in Switzerland was weak amid concerns over lay-offs and the loss of a symbol of national identity. The failure of the project was perhaps also a reflection of the Swiss reputation for being aloof, making it difficult for Swissair to form lasting alliances.

Alain Bandle, who joined Swissair in 1993 from Hewlett-Packard (HP) as vice president in charge of the core marketing functions, product development, distribution, revenue management, communication and frequent flyer programme, commented:

It was an ambitious, visionary strategy and we got really close. The failure of the Alcazar talks demonstrated the difficulties that major airlines faced in putting politics and egos aside.¹

This failure, along with Swissair's exclusion from the EU market, led the airline to turn to management consultants, McKinsey, to find a solution to its problems.

McKinsey's vision for Swissair

McKinsey proposed a dual strategy for the airline. It consisted of acquiring minority stakes in foreign airlines – to strengthen the airline business and build up a critical mass in the EU market – and implementing horizontal integration into airline-related activities in an attempt to diversify the portfolio.

Over the following decade, Swissair became the major account for McKinsey in Switzerland – by a wide margin.

According to Bandle, McKinsey's influence on Swissair was powerful:

We got overwhelmed with so-called analysis. McKinsey people have very sharp analytical minds and their job is to concentrate exclusively on their project. Other managers still had their day-to-day jobs. Their reports were often left unchallenged and their word was taken for granted. It was actually incredible that the whole strategic function was almost entirely outsourced to the consultants.

Lukas Mühleemann – an ex-McKinsey partner – was a heavy promoter of all this in his capacity as a Swissair board member. He was well connected to the McKinsey network and well briefed by his former McKinsey colleagues. He had access to the executive committee of the board and the CEO, Otto Loepfle.

The overall effect of this outsourcing of strategic control – with McKinsey at times almost bulldozing the organisation into following its advice – was that, bit by bit, Swissair lost its own internal ability to carry out strategic thinking.

The McKinsey proposal was a three-pronged approach: revenue enhancement, cost reduction and reduction of asset intensity. McKinsey predicted that in the future airlines would fall into one of three categories – network managers, capacity providers and service providers – and that the network managers would rake in the lion's share of the profits. These airlines would act as the integrator for networks, product design, scheduling, pricing, brand management and sales. Key success criteria would be access to a sufficiently large market to supply the global network, together with strong marketing and cost management competences within the organisation. In McKinsey's view, Swissair fitted the bill.

[Airlines like] Swissair, which operate out of hubs that are parts of global networks with more capacity than their local market can support, can also perform as network managers by continuously importing traffic from other

markets. Airlines that have limited intercontinental or even Europe-wide routes but dominate their national markets will have to ally with network managers that are interested in exploiting the market potentials these carriers control.²

On the cost side, Swissair was paying a heavy price for its stable industrial relations compared with its European neighbours – Swissair crew costs were one-third higher than BA's. The disparities had to be addressed, but in doing so Swissair would also need to develop new, more sophisticated skills to manage employee relations across the entire network.

According to McKinsey, Swissair would have to hone its brand management skills to cover not only its own operations but also those of its future capacity providers. The trick would be to develop a brand concept across the network but at the same time avoid dilution of the Swissair brand.

In 1995 Swissair, in close consultation with McKinsey, restructured its organisation into a holding group. Under the new structure, Swissair Group headed up four divisions – SAirLines, SAirLogistics, SAirServices and SAirRelations – each with operations around the world related to the travel industry. By 1997 the non-passenger-related businesses accounted for over 60 per cent of the Group's total turnover of US\$7.6 billion, compared with 24 per cent in 1990.

During the mid to late 1990s, as competition in the global airline industry intensified, more and more cross-continental alliances developed. In 1996 BA, American Airlines, Cathay Pacific and Qantas announced the formation of a new global alliance – Oneworld. In 1997 two others followed, Skyteam (led by Air France) and Star Alliance (initially comprising United, Lufthansa and SAS). Swissair followed suit in early 1998 with the Qualiflyer Group, initially consisting of six member airlines: Swissair, Sabena, Austrian Airlines, TAP of Portugal, Turkish Airlines and AOM of France.

Meanwhile, in an attempt to gain control over capacity providers, Swissair had started to buy equity stakes in regional European airlines. According to McKinsey:

Equity stakes are advisable ... Even so, it is useful under such circumstances to examine the specific reasons for taking an equity stake. One valid reason is to pre-empt competitors establishing a threatening position ... In addition, an equity stake can, at times, earn an attractive return for the network manager as a straight financial investment.³

Spreading its wings into Europe

Acting on McKinsey's strategic proposal to become a network manager, in May 1995 Swissair bought a 49.5 per cent minority stake in the Belgian national airline, Sabena. Founded in 1923, Sabena had grown over the years so that, prior to the deal with Swissair, it was operating flights to Africa, North America and the Far East but with 80 per cent of its traffic still within Europe.

Sabena was not in great shape, however. Having shown a profit only once in its life, the state-owned airline was dogged by poor labour relations. The Belgian government had been casting about for a suitor for some time and a collective sigh of relief came with the offer from Swissair. In view of Sabena's poor financial position, the response from analysts was less than effusive.

Bandle, who was charged with negotiating the deal and then leading the integration process, recalls:

I will never forget my discussions with Sabena's CEO Pierre Godfroid – he almost fainted when, with the help of my Credit Suisse First Boston people, we showed him that Sabena's value was 'zero'. What we bought at the time was not Sabena airline. Through the acquisition of a stake in Sabena, we gained access to a well-established, modern hub in the heart of Europe. There were no constraints attached as the planes could fly in and out 24 hours a day. It had expansion possibilities. It carried over 4 million passengers and had a high potential to grow in a market of 40 to 50 million people.

Despite the elaborate demonstration of zero value, Swissair paid SFr 240 million cash and SFr 20 million in participating certificates. In addition, the Belgian state received SFr 159 million of 6.5 per cent interest-bearing loan warrants to pay off Sabena's previous partner, Air France. Swissair was granted an option on a majority shareholding of 62 per cent, later increased to 85 per cent.

For Swissair, one of the implicit assumptions in the financial benefits of the deal was the realisation of substantial synergies on integrating the two airlines. Bandle reflected on the whole experience:

We wanted to have the best possible – and from the EU perspective totally acceptable – integration of these two airlines. We had far-reaching plans to have their entire revenue management system and their entire IT infrastructure running on Swissair's IT platforms like we did with Austrian Airlines. We hoped

to be granted antitrust immunity, a step that would allow us to more closely coordinate timetables, fares and destinations and to offer a first-class product in terms of connections, through check-in and other services. McKinsey had done a great job in helping me to identify where we could get synergies. But at the end of the day it was not McKinsey who was going to make the synergies happen – it was the people that were in charge of parts of the business.

Meanwhile, deteriorating group financial performance, mainly due to poor results in the airline division, put the CEO, Otto Loepfe, under strain. He started to come under fire from the board who decided, in September 1995, that Philippe Bruggisser, a long-time airline industry man and officer at Swissair, would gradually assume full responsibility for the Group.

Bruggisser turned round the associated companies in a very aggressive manner, particularly the catering. He is very tough and not wedded to the airline industry like Loepfe. He is looking at every part of the business. Nothing is sacred.⁴

In 1996, Bruggisser became president and CEO of the Group. Paul Reutlinger, executive vice president marketing and ground services, was nominated as Bruggisser's deputy. Described by his colleagues as a hugely charismatic, creative individual, a formidable marketer, excellent people manager and a good leader for a service-oriented organisation, he had aspired to be Loepfe's successor and was frustrated at having to work under Bruggisser instead. A year later, Jeffrey Katz, a US citizen recruited from American Airlines, was appointed CEO of the airline division.

Despite Bandle's best efforts at the outset in identifying and validating synergies with management on both sides of the business, the integration process did not go well and the situation was becoming untenable.

The dispute between former management and the Sabena unions was increasingly becoming one of personalities rather than issues. It jeopardised both the further development of the company and the confidence of its customers.⁵

The board decided to take action and placed Reutlinger in charge of Sabena. As Bandle noted:

Reutlinger finally got an airline to run and he was now less interested in integrating anything into Swissair.

Of the 12 synergy initiatives initially identified, only 2 or 3 survived. Sabena's losses in 1996 amounted to €220 million and the passenger load factor had decreased to an average of 59 per cent – the lowest in Europe.

Against this backdrop, in November 1996, the CEO of Swissair – Bruggisser – announced that the investment in Sabena would be written off at once in Swissair's books. Bruggisser, who was known to have opposed Swissair's acquisition of the stake in Sabena, announced that Swissair should have probably paid less for its stake in Sabena.⁶

Swissair's share price plummeted. Over the next 12 months, the struggle to achieve the promised synergies, and their cost savings, continued. Then in November 1997 Sabena placed an order for 34 new aircraft (up from the originally intended 17) with Airbus, at a cost of \$1 billion – five times the company's entire capital at the time.⁷ In addition to the huge acquisition costs, 650 Sabena pilots – who were used to flying Boeings – had to be retrained at a cost of €17 million. The actual financing for this investment was never disclosed in detail. But in 1998 Sabena announced a profit – for only the second time in its 75-year history.

At the end of 1999, it transpired that the 1998 result was a blip and an accounting one at that. The profit was only generated by including the sale of the old Boeing fleet. By 1999, the flight activity made an operational loss of €39.6 million and the cash position had shrunk from €223 million in the 1998 books to €124 million a year later. To make matters worse, four more A340-300 aircraft from Airbus had been ordered to be delivered in 2001 and 2002, creating a funding requirement of €513.5 million.

The Belgian government, still in possession of the majority stake, became increasingly worried. As Sabena's debt mounted to €2.3 billion, the government's position was far from enviable and the obvious solution was to persuade Swissair to take up its option on the 85 per cent shareholding. As 2001 approached, the government asked several investment banks to assess the financial situation at Swissair but little information was available. Moreover, it was clear that no other European airline was in the market for a partner, let alone one with Sabena's financial record and a strategy which was completely aligned with that of its minority stakeholder.

Hunting for potential partners

In late 1997, on the back of Swissair's Sabena acquisition, McKinsey came up with a new multi-partnership strategy, known as the 'hunter'

strategy. The premise was that by creating cross-equity shareholdings with European national airlines, Swissair could bypass the need to negotiate bilateral traffic rights with the individual EU markets.

The focus of the hunter strategy was markets with growth potential (namely Belgium, Austria, Finland, Hungary, Portugal and Ireland) as opposed to the more mature European markets of France, Germany and the UK. Regional carriers landing at the now massively expanded Zurich hub were intended to be used as feeders to Swissair's intercontinental flights. According to McKinsey, an increase in capacity and passenger frequency would make Swissair an attractive partner for a large American airline and make it into 'the fourth power in Europe'.⁸

International expansion looked like a bold but reasonable idea to Bruggisser. Following McKinsey's advice, Swissair started to invest in its new Qualiflyer partners and purchased a 10 per cent stake in Austrian Airlines and a 5 per cent stake in Delta in addition to its Sabena shareholding. Between 1998 and 1999 interests were also acquired in three French airlines: AOM, Air Liberté, and Air Littoral, and in the Volare Group, LOT (Polish airlines) and South African Airways (SAA) for a total investment cost of SFr 4.1 billion. All the acquisitions were approved by the board, based on management recommendations. With the exception of LOT, all the acquired companies were in a poor financial state and none were in the target markets previously identified by McKinsey.

Bandle (who became a member of the supervisory board of Austrian Airlines in spring 2001) gave his take on events at the time:

Bruggisser's vision was that in the long run the alliances would not be a stable form of cooperation. It was clear to him that the alliance agreement structure had an expiry date, particularly once cross-country mergers were allowed – which he felt would happen sooner rather than later. Bruggisser's idea was to build a portfolio of airlines, so once the cross-country mergers were allowed he would be in a position to consolidate his stakes in minority holdings.

After a series of expensive investments, including the 49 per cent of Sabena, and expansion into airline catering, airline maintenance, and cargo and ground services, Swissair should have been, in theory, closer to realising its objective. But as oil prices rocketed in 1999/2000, the airline industry, including ancillary services, suffered. This factor, together with the poor performance of Swissair's investments, led the board to question the company's ability to finance the underlying strategy.

A distinguished, but ineffective, board

Proposals to the board were signed and presented for approval by the CEO. The holding structure of the Swissair Group was highly complex, with the net result that it was virtually impossible for the board to get a clear view of the group's overall financial position at any moment in time. Of significance also is the fact that the CFO, Georges Schorderet, who came on board in 1995, was not part of the Group's mergers and acquisitions team.

Between 1995 and 1999, the number of board members was reduced from a very top-heavy 20 to a much more manageable 9. The list of the remaining members read as a roll call of the great and good of the Swiss business world, including Lukas Mühlemann, who was chairman and CEO of Credit Suisse (Swissair's principal bank) and the former CEO of McKinsey Switzerland; Eric Honegger, a powerful political figure, former finance minister for the canton of Zurich and chairman of the Swissair board; and Mario Corti, CFO of Nestlé. Being asked to join the board of Swissair was a 'certification that one had arrived in the corridors of power ...' said one of the members, Bénédict Hentsch (managing partner in the private bank Darier, Hentsch & Cie), in an interview.⁹ None of the nine board members had a background in the airline industry. Honegger, quite astonishingly, believed this was undoubtedly an asset:

I am not a friend of the notion that at the board level one should in a way duplicate the management requirements. Management has the know-how to lead the airline. The board has other tasks, it must especially carry out the monitoring function.¹⁰

Direct remuneration of board members was almost negligible, with fees of SFr 800 per meeting and the equivalent of approximately SFr 15,000 in shares. However, a seat on the board entitled members and their families to seats in first class on unlimited Swissair flights around the world. Board meetings themselves were reputedly preceded by gastronomic extravaganzas, which may well have had an impact on the quality of the ensuing discussion. Bandleⁱ commented on his experiences with the board during the Sabena negotiations:

I was reporting to the board on a monthly basis during these five months. There were tons of issues we had to address in terms of unions, cost cuts, fleet

i After the Sabena acquisition and integration, Bandle left Swissair to rejoin HP as General Manager Computer Systems, Germany/Switzerland.

integration but very, very few questions were asked and there was very little discussion at the board level ... I was not impressed by the discussion or the decision-making process.

Bandle talked about Bruggisser and his role as CEO:

Bruggisser always impressed me as a manager who did his homework, who was meticulous about due diligence ... He was a very sharp dealmaker and a tough negotiator. He worked from 6 in the morning till 10 at night. He was a loner.

And suddenly, the same Philippe Bruggisser goes off and buys a 49.9 per cent stake in LTU – a German tour operator and charter carrier – for SFr 894 million in September 1998. I was in Düsseldorf at the time ... and people, knowing that LTU was in such a big trouble, were asking me why Swissair wanted to buy it. It was not even part of the hunter strategy!

By 2000 LTU was showing a loss of SFr 390 million. The same year, clashes of opinion developed between Katz, CEO of the airline business, and other senior management, over both Katz's personal ambitions and the strategic direction of the airline division. Katz eventually gave up and left. The board decided the role should be transferred to Bruggisser, in addition to his existing responsibilities. But Bruggisser was beginning to lose the confidence of his closest colleagues on the management committee. Communication between the CEO and the management team started to break down, to the extent that Bruggisser relied on an external consultant for due diligence work on a merger with Alitalia, Italy's national airline. The board fully endorsed his pursuit of the project despite Alitalia's financial and operational problems, second only to those of Sabena in severity.

Reality dawns

To meet EU requirements about ownership of airlines, acquisitions of minority interests under the hunter strategy were invariably accounted for in complex financial structures (special purpose vehicles – SPVs) which ensured they remained only as a minority shareholding in the consolidated financial statements. This was despite Swissair having, in some cases, effective operational control over the entities, a situation which would normally require the group to fully consolidate the interests as subsidiaries. The additional financial commitments required for these SPVs were putting

increasing pressure on the company. McKinsey performed a review of the financing requirements in August 2000 which resulted in estimates of between SFr 3.25 billion and SFr 4.45 billion. With no slack in the balance sheet, the board was left with little choice but to abandon the hunter strategy:

The Board realised that the depth of the resources required to implement the chosen strategy, in terms of time, capital and management capacity, was greater than the Group could provide. The lack of ample financial resources to pursue additional acquisitions and to carry out the required refinancing plans in Germany, Belgium and France forced the abandonment of this strategy.¹¹

Simultaneously, Bruggisser's 22-year career at Swissair was terminated and Honegger, the chairman, became the Group's interim CEO, effective from 23 January 2001. Two months later, nine of the company's ten directors announced their resignations to take effect over 13 months. This caused a great outcry in Zurich and Geneva at the directors' '[refusal] to assume responsibility for their own strategy'.¹²

Mario Corti, by then chairman of Swissair, was appointed Group CEO in March 2001, in the hope that he could rescue the ailing airline. An MBA from Harvard, his banking background, together with his tenure as Nestlé's CFO, made Corti one of Switzerland's most respected business figures.

At his first press briefing in April 2001, Corti broke the bad news that in 2000 Swissair had sustained its biggest ever loss of SFr 2.9 billion, despite a 24.8 per cent increase in turnover. By mid-2001, the Group's balance sheet was only 5 per cent equity and 95 per cent debt, which had escalated to SFr 17 billion. The CFO, Schorderet, immediately came under fire from shareholders demanding to know why his indication of a SFr 200 million profit less than six months previously was so extraordinarily far off the mark. Corti rapidly replaced him, appointing Jackie Fouse from Nestlé to take over in June 2001. In a similarly swift action, PwC was replaced as external auditors by KPMG, which was given the mandate 'to go through the whole business and discover whether there are any skeletons left in the closet'.¹³

As a result, the Group restated its balance sheet as at 31 December 2000, cutting its equity from SFr 1.2 billion to SFr 716 million. Corti did not shy away from tough decisions and took an axe to Swissair's non-core businesses:

Our main priority is to reorganise the Group's airline sector, the first pillar of our dual strategy, and restore it to a sound financial condition ... From where we stand today, it will be impossible to ignore broad restructuring measures.¹⁴

The full cost of Swissair's expansion strategy was revealed to have been heavy indeed. Although operating profit fell only 11 per cent to SFr 603 million in 2000, exceptional costs and losses from investments totalled SFr 3.2 billion. The equity value on most of Swissair's airline investments, including Sabena, LTU, AOM, Air Littoral, Volare, LOT and SAA, was written down if not written off entirely. Provisions were also made for Swissair's share of the losses on investments in the same airlines. In all, 72 per cent of Swissair's shareholder equity was wiped out.

The disposal plan was stepped up in order to counter the steadily growing debt, although many transactions required further cash outlays in order to stem the losses. The company reneged on its agreement to increase its stake in Sabena to 85 per cent and inject more funds, but the Belgians sued. An agreement was eventually reached in August 2001, with Swissair Group and the Belgian government providing Sabena with cash funds of €258 million and €172 million respectively. Swissair was allowed to walk away without taking up the further stake in Sabena.

Swissair also managed to rid itself of its French airline interests. A total of €200 million was contributed to the relaunch of AOM-Air Liberté by a former Air France pilot. SFr200 million was committed to a restructuring plan for Air Littoral, which was taken over by the airline's former CEO.

The eight-month struggle to get Swissair back on its feet was futile, however. The unforeseen events of 11 September 2001 had a disastrous and immediate effect on the entire airline industry as people were reluctant to fly. Swissair was no exception. Its aircraft were grounded on 2 October 2001 and shortly afterwards the airline went into receivership.

Swissair Group collapsed with net liabilities of SFr 1 billion. But of its SFr 7.8 billion of assets, SFr 7.3 billion were either loans to Group companies or equity investments in subsidiaries, most of them worthless. The final cost to banks and bondholders topped SFr 6 billion.

Aftermath

Switzerland's economic and political elite scrambled to save not just the airline but also – and more importantly to them – the nation's image. Project Phoenix was conceived to give rise to a new flag carrier for Switzerland out of the ashes of Swissair. After much arm-twisting, a total of SFr 2.7 billion was pledged from both government and corporate sources, among them the cantonal authorities in Zurich and the Swiss banks UBS AG and Credit Suisse Group. Other corporate investors included Novartis, Roche, SwissRe and Nestlé, which poured millions into

the project in what was billed as a ‘triumph of corporatism’¹⁵ but held few apparent benefits for their own shareholders.

Under Phoenix, the regional carrier Crossairⁱⁱ obtained leases on planes from Swissair’s fleet and took over the slots for the majority of Swissair’s domestic destinations. However, transfer of the international slots could not be registered before March 2002 so a further SFr 1.5 billion was sunk into Swissair to keep it aloft until then, when Swiss International Air Lines (Swiss) was finally born.

The rebranded Swiss got off to a shaky start and immediately began the first of many rounds of restructuring, each involving further redundancies and aircraft disposals. A loss of nearly SFr 1 billion was posted in the first year of operations, 2002. This was narrowed to SFr 687 million for 2003 but by this time the airline was considered to be the ‘dead man walking’ among European airlines. Suffering from a high cost base with soaring fuel costs, an extremely tight market in the wake of both the war in Iraq and the SARS virus, and voracious competition from the low-cost carriers, Swiss was doomed almost from the outset. And strong airline alliances such as Oneworld and Star Alliance, which might have been capable of helping Swiss shoulder the burden, were shunning any of Swiss’ efforts to woo them.

Eventually, after an aborted attempt to hook up with BA, rumours began to circulate of a potential deal with Lufthansa, heightened by the appointment of an ex-Lufthansa manager, Christoph Franz, as CEO of Swiss in April 2004. The proposed takeover was announced in March 2005 with Lufthansa set to pay an estimated total of €310 million for the outstanding shares of Swiss. Lufthansa gained access to the Zurich hub and a highly sought-after business-class and first-class travel customer base. Swiss, for its part, was assured of its precious independence and continued operation of Zurich airport as an intercontinental hub, thereby guaranteeing jobs as well as sustaining the tourism industry and business sector. Despite initial opposition and continued misgivings over the sale of the national flag carrier, opinion polls eventually tilted in favour of the deal. And somewhat ironically, in finally gaining full access to the EU market, the Swiss national airline ultimately scored the goal it had been seeking for well over a decade.

What went wrong and lessons to learn

McKinsey had proposed an ambitious strategy with its concept of network managers. It probably underplayed the difficulties of achieving

ii Previously a Swissair subsidiary.

this position, given the political issues with the status of national carriers; the tricky industrial relations; and the need to protect the Swissair brand. This was particularly true with Sabena. The strategy was then poorly implemented and was the root cause of Swissair's downfall. Had there been more effective management control and board oversight, the strategic errors might well have been avoided or, at least, identified earlier and rectified in time to save the pride of Swiss industry. They were not, and over the course of five years, the airline relentlessly pursued an acquisition and investment policy which drained resources and gradually eroded shareholders' equity until it was too late.

The dangers of outsourcing strategy

One of Swissair's fundamental errors was effectively to delegate its strategic decision-making to McKinsey. Unsurprisingly, the strategy devised was one that ensured Swissair's continued reliance on McKinsey through the ensuing series of acquisitions of minority stakes, so much so that the McKinsey consultants became almost indispensable to Swissair and a de facto part of the operations. In parallel, Swissair's own internal capacity for strategic thinking diminished to the extent that McKinsey's proposals, assumptions and predictions were rarely questioned or challenged, by either management or the board.

The need to protect the brand was sidelined

Historically, Swissair's strongest asset had been its reputation for first-class service, which set it apart from many of the global players which dwarfed it. McKinsey's hunter strategy underplayed the need to safeguard Swissair's quality reputation when taking minority equity stakes in airlines where it would be unable to dictate quality standards and therefore put its brand at risk.

Poor implementation issues

The hunter strategy prescribed the acquisition of minority equity stakes of between 10 per cent and 30 per cent but this was not adhered to and with the exception of SAA, all of Swissair's other investments were in excess of 30 per cent, many of them 49 per cent. This effectively exposed

Swissair to greater financial risks but without the benefit of full control to mitigate them. It also bought stakes in airlines outside the proposed target markets.

And the financial risks were not small. While McKinsey's earlier advice was that the acquisitions should be attractive as straight financial investments as well as for strategic purposes, most were in a poor financial state. Swissair ended up paying over the odds for the minority interests while not having the power to turn around the operations and claw back some of the investment, since most of the companies continued to be run independently of Swissair.

The pitfalls of large minority investments

The Sabena investment provides a prime example of the dangers involved in large minority investments. Despite knowing that, in purely financial terms, Sabena was worth nothing, Swissair paid SFr 240 million in cash for 49.5 per cent of the equity. As control of the airline remained in the hands of the Belgian government, the anticipated synergies, particularly regarding employee costs, were never realised. Sabena turned into a black hole, into which Swissair poured more and more cash, including financing the purchase of a fleet of new aircraft.

Even after the investment in Sabena had been written off in 1996, which should have served as a warning sign for the board, management and external stakeholders, the acquisitive strategy continued and the same mistakes were repeated.

As well as acquiring a raft of minority stakes in smaller airlines, Swissair diversified into other areas, many of which were far removed from its core competences. While some of these (such as Gate Gourmet) proved to be a success, with others the potential rewards were less evident and another drain on Swissair's limited resources.

The drawbacks of an ornamental board

Membership of the Swissair board was much sought after, offering as it did, entry to an elite club and public affirmation that one had reached the pinnacle of one's career. None of the directors had any airline experience to speak of, and given the degree of cross-directorships between Swissair and companies such as Credit Suisse, Nestlé, UBS and Darier, Hentsch & Cie, it was effectively an 'old boys' network. Until 1999 there were some

20 members, making it an unwieldy forum which generally accepted, without much questioning or challenge, the acquisition and other strategy decisions. There was also an element of complacency that came from Swissair's successful past and brand reputation, which perhaps led the board to think 'it couldn't possibly happen to us'.

The dominant CEO again

Although not as directly responsible for the downfall of Swissair, as were the CEOs of WorldCom, Parmalat and Tyco, the highly ambitious and power-hungry Bruggisser must shoulder some of the blame. His judgement became increasingly questionable, as evidenced by his unilateral decision to acquire 49 per cent of the problem-riddled LTU, which did not even fall in the scope of the hunter strategy. Furthermore, the clash between Bruggisser and the equally ambitious Katz, confused the lines of operational control and affected the orderly running of the group as this conflict percolated down through the organisation.

Lack of internal controls and clear financial information

There was a general lack of strong financial management within the Swissair Group, exacerbated by poor information systems. The fact that the Group CFO did not figure in Swissair's mergers and acquisitions processes underlines this deficiency.

Within Swissair itself, the Group holding structure became increasingly complex and each acquisition only added to the problems. Combined with inadequate forecasting and poor financial reporting, the result was that even those responsible for Swissair's day-to-day management did not have a clear picture of the overall position until it was too late. This was exemplified by the 2000 forecast profit of SFr 200 million turning into a loss of SFr 2.9 billion. Consequently, the time to take effective remedial action had already passed before the full extent of the problems was realised. By then it was too little and too late.

The auditors, PwC, were replaced by KPMG on Corti's arrival, and immediately questions were asked as to why PwC had not raised warnings about asset impairment given the subsequent write-down of nearly three-quarters of shareholders' equity. Similarly, the rating agencies did not recognise the true state of the Group's financial position in sufficient time and reacted only when Swissair itself identified and announced problems.

Refusal to relinquish control

In contrast to some of the other collapses, where excessive executive compensation played a significant part in influencing management decisions, this was not the case at Swissair. However, an overriding objective for the board and management alike was to retain the airline under the national banner and Swiss control. This desire to preserve the autonomy and power of Swissair manifested itself at an early stage with the collapse of the Alcazar alliance, and from then on in the unwillingness of Swissair to take a secondary role in any other partnership. This was not helped by the refusal of the Swiss electorate to join the EU, thereby handicapping Swissair's ability to compete within the open-skies policy.

The key messages are:

1. Overreliance on outside consultants can be dangerous. If consultants are dictating strategy, it is a good idea to ensure that they also carry a degree of responsibility for its implementation, perhaps by structuring the fee arrangements accordingly.
2. Board members need to bring expertise as well as prestige to the table. They should not have potential conflicts of interest if they are to fulfil their main function of ensuring that the company is well run and respects corporate governance best practice.
3. Efficient management information systems are essential to ensure that management and directors have the data quickly and accurately enough to enable correct and timely decisions to be made.
4. Hubris (or national pride) can get in the way of making the right decisions. The refusal to contemplate Switzerland without a flag carrier was ultimately to the detriment of shareholders and other stakeholders alike.

Notes

- 1 This quote and all others from Alain Bandle came from interviews with IMD research associate Inna Francis.
- 2 C. Barton and L. Bragshaw, 'Industry Focus: Is there a Future for Europe's Airlines?' *McKinsey Quarterly*, Issue 4 (1994), p. 29.

- 3 C. Barton and L. Bragshaw, 'Industry Focus: Is there a Future for Europe's Airlines?' *McKinsey Quarterly*, Issue 4 (1994), p. 30.
- 4 *Airline Business* (1 February 1996).
- 5 Sabena's official statement (from the Sabena website).
- 6 Reuters (3 November 1996).
- 7 Peter Gumbel, 'The Last Days of Sabena', *Time Europe Magazine*, **160**(18) (28 October 2002) www.time.com.
- 8 Results of Ernst & Young's investigation regarding Swissair; January 24, 2003.
- 9 Interview with the *Institutional Investor*, **36**(2) (2002).
- 10 *Neue Zürcher Zeitung* (10 March 2001).
- 11 Annual Report 2000.
- 12 *Time* (7 May 2001).
- 13 *Financial Times* (12 July 2001).
- 14 Shareholders' meeting (April 2001).
- 15 Marcel Michelson, 'Rescue Spells No Swiss Airline Success Yet', *Reuters News* (23 October 2001).