1. **Describe Kiwi's entry strategy and explain why it was initially successful. Where did they go wrong and why?**

The airline industry has lower barriers confined to those carriers with strong hub dominance. In the main, the airlines did not know how to get along with one another. The history of the industry in both its regulated and deregulated phases showed how difficult it was to restrain overcapacity, and how overcapacity led, almost inevitably, to brutal price wars. With such low barriers to entry and exit, Kiwi did not have a problem getting into the industry.

Kiwi's entry strategy was uniformly well-conceived. It made Kiwi hard to kill without threatening the established carriers.

Kiwi's management--experienced from working at established carriers—understood that they should not directly antagonize the established carriers. They started with three small routes from Newark Airport to different hubs with different incumbents and unthreatening enough so that it would cost the airlines incumbents more to eliminate them—"to swat a fly off their backs," in Iverson's terms—than to let them live. Their choice of routes was part of this strategy. The Newark-to-Chicago route would incur only minimally into United's and American's business. The Newark-to Atlanta route would nick Delta; the flight to Orlando would take some business from Delta and Continental. By **spreading the pain around**, Kiwi *minimized* the loss to any single competitor. It also **reduced its business risk** by flying three routes; if any of the major carriers started a fare war to eliminate Kiwi, it would still have two routes unaffected by the competition.

Kiwi also **avoided challenging the incumbent carriers directly on price**. Kiwi pegged its ticket chart to the lowest restricted fare the competition was offering. It did enhance service. Its tickets were unrestricted and required no advance purchase. It reconfigured the planes to reduce the number of seats from 170 to 150 for more leg room, putting all passengers in the equivalent of business class. It served hot meals rather than snacks. .

It had no substantial budget to promote itself in the public media, so it avoided another direct challenge to the incumbents. **Kiwi quietly and unobtrusively entered the market.**

Kiwi did not poach pilots, flight attendants, or other personnel from the existing airlines. A large part of its reason for being was to put these people back to work in an industry they loved and in a company they thought they could run more intelligently and profitably than the ones that had laid them off. These employees were on a mission. Kiwi appeared to be on track for a profitable, though small-scale, future.

Unfortunately, Kiwi could not sustain its disciplined approach. In the spring 1992, the airline had two hundred employees, two leased planes, and six scheduled flights per day. By Sept. 1994, it had grown to one thousand employees, twelve planes, and forty-seven flights. It had complicated the route structure by more than doubling the direct routes connecting these cities. Kiwi's original strategy—to not get so big as to challenge the existing carriers, and to focus the business on a **single hub, simple route structure**, and an identifiable **target market**—was now history. Kiwi was going to grow outside its area

of competitive advantage and thus into losses. Kiwi's expansion increased its costs without having economies-of-scale to absorb them or with providing better service to its customers. Increased size and a wider route structure could not provide Kiwi with economies of scale comparable to those enjoyed by the major airlines. Growth outside of its focused strategy undermined the Kiwi's operating efficiency. Nor could they compete with the established carriers on customer preference. More frequent flights, more useful frequent flier programs, and a perceived higher level of safety—an advantage abetted by the Value-jet crash in the Spring of 1996—all favored the big carriers. Meanwhile, **Kiwi's larger and more complex route structure led to higher costs without substantially enhancing its appeal to customers.**

Growth also undermined Kiwi's anticipated operating efficiency. A structure of operations that had been well adapted to Kiwi's original strategy proved unsuitable in its new growth mode.

Kiwi filed for Chapter 11 bankruptcy in October 1996. Kiwi's quest for growth at all costs led it to abandon a strategy that seemed to be working albeit on a small scale. Strategy ought to be a guide for action, not a rationalization for otherwise unrealistic business goals.

2. **What is the evidence that there were no existing barriers to entry in the airline industry in the 1980's?**

Benjamin Graham in *The Intelligent Investor,* warned about investing in a growth industry without competitive barriers:

Such an investor may for example be a **buyer of air-transport stocks** because he believes their future is even more brilliant than the trend the market already reflects. For this class of investor the value of our book will lie more in its warning against the pitfalls lurking in this favorite investment approach than in any positive technique that will help him along his path.

From 1949 to 1970, revenues grew faster than expected but overcapacity made for abysmal profits.

Barriers to entry seemed low. Industry inputs (maintenance, ground services, reservations), for instance, could be contracted from other firms. Airports were public property and the FAA provided communication facilities. Entrants could even lease airplanes instead of buying them outright. The barriers to exit seemed low as well. En entrant could quickly redeploy airplanes from one market to another, prompting CAB Chairman Alfred Kahn to call them **"marginal costs with wings."**

Existing firms disappeared and new ones entered, with a pace of turnover that we do not expect to see in an industry with incumbent competitive advantages. The operating margins and returns on investment for the three leading carriers reflect intense competition among incumbents and newcomers alike. In the main, deregulation had been a bonanza for passengers, at least for those whose primary concern was price. But competition had been hard on carrier profitability. From 1975 to 2000, the

operating margins of the three major carriers, United, American and Delta Airlines fluctuated between 10% at the peak and a negative 7 percent. The operating margins and returns on investment for the three leading carriers reflect intense competition among incumbents and newcomers alike. Many airlines such as Pan Am, TWA, and Braniff, have long since disappeared.

Local dominance in the hub market did provide some stability to particular airlines. Within these hubs, they maintained share stability and even profitability, as the combination of some consumer preference and local economies of scale created a competitive advantage. Travelers were more likely to make their first call to the carrier with the most flights to the most destinations and the most convenient gates; size begat traffic. And the economies of scale available to large carriers within the hubs were considerable: centralized maintenance; better deployment of crews, ground staff, and even airplanes; targeted advertising and promotion. Once a carrier dominated a hub (like United Airlines in Chicago/Denver), it could spread these, essentially fixed costs, over a larger passenger base.

The efficiencies of the hub-and-spoke system, fortified by yield enhancement through a complex fare structure, provided some relief to the established and well-run carriers. But as shown in the table below, overall airline industry performance was erratic and operating margins were low—not a sign of an industry with competitive barriers to entry.

Airline Industry Performance: Note the erratic operating margin as revenues grow		
	Revs. Per Passenger Mile (bil.)	Operating Margin %
1978	227	5.96
1979	262	0.73
1980	255	(0.66)
1981	249	(1.24)
1982	260	(2.01)
1983	282	.8
1984	305	4.90
1985	336	3.01
1986	367	2.62
1987	404	4.33
1988	423	5.35

END