Flying on more than a wing and a prayer:
Navigating the skies for Flyqual Airlines

This article written by Shuaib Masters and Steve Corless, members of FTC Kaplan’s London TOPCIMA team, provides an initial perspective and observations on the latest TOPCIMA pre-seen case scenario, assessment matrix and exam requirements.

Brian Whitaker, The Guardian commentator, noted in an article last September, “I have often travelled on planes next to Christians who crossed themselves or Muslims who whispered a prayer before take-off. It happens in all faiths, so the reaction of a Canadian airline to a Jewish man who prayed in his seat seems both bizarre and insensitive: he was thrown off the plane”. This anecdote is useful in highlighting the turbulence in the airline industry where plain sailing can quickly turn into a stormy journey over seemingly minor incidents, symptoms of larger issues, which become full blown crises within the backdrop of an environment influenced by a host of PEST (political, economic, social and technological) factors.

Understanding the context of the case organisation is crucial in viewing the larger strategic issues at stake emanating from the pre-seen material as well as evaluating the alternative solutions available for the problems and proposals that will be presented by your Examiner's unseen material. The case organisation Flyqual, presents the following context:

- a truly global business in an industry that is global in nature
- a business established more than 50 years ago
- a company owned by two large listed conglomerates
- operating in one of the most volatile, dynamic and riskiest of mature industries delivering a rollercoaster ride of numerous peaks and troughs for the players in its markets
- strategically at a cross-roads in deciding its future strategy because of stakeholder conflict and PEST factors, particularly technological and economic.

Once again, your Examiner has largely retained his / her user friendly case writing style, and pattern of contents for Flyqual: firm history and shareholding structure; industry background and future prospects; background of management personnel; firm's position in the market; a range of external market and internal functional issues including staff issues; future challenges and prospects; and ending with basic extracts of the financial statements for the last period.

Although Flyqual is not immediately in crisis and in need of radical surgery, this could change in an instant where there are outsourced service suppliers, dependency on the human factor for its chosen strategy, a dramatically dynamic environment, and only two suppliers of replacement planes.

The case study approach of TOPCIMA attempts in a small way to simulate practical, real world issues, and requires you to identify really crucial issues facing the case organisation from all the material given to you. Your Examiner has complained on many occasions that candidates cannot see the “big picture” so we hope that this article will give you a running head start towards the “bigger picture”.

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One of the authors of this article would like to refer you to his article on the last case pre-seen; Kadgee ("Rags to Riches") where the analogy of the positive seagull approach (a strategic overview of the broad issues against the requirements of the assessment matrix) was drawn. Flyqual's context requires us to take a view from an altitude far higher than a seagull can fly. However, we can draw from NASA’s Earth Science Enterprise Strategy 2003 for an approach to Flyqual's larger context:

“From space we can view the Earth (substitute: global economy) as a whole system, observe the net results of complex interactions, and begin to understand how the planet is changing in response to natural and human influences (substitute: PEST factors).....it is imperative for us to ask, “How is the Earth system changing, and what are the consequences for life (airline industry and Flyqual’s stakeholders) on Earth?”

At this point, it may be useful to review question four on the CIMA Paper 6 Business Strategy current syllabus Pilot paper at http://www.cimaglobal.com/cps/rde/xbcrr/SID-0AAAC544-7BE0289F/live/P6_pilot_paper.pdf as it provides a useful, quick microcosm and contrast of the competitive forces facing traditional airlines and how the newer “no frills airlines” have manipulated these forces for competitive advantage. It also examines the sustainability of the two starkly diverse strategies, one based on premium pricing supported by high levels of differentiation, and the contrasting low cost “no frills” approach.

The airline context makes for a very interesting case, one we all can relate to as customers. Such is the nature of convergence in the modern global economy and the breakdown of world trade barriers, it would be very unusual, barring aviophobia or pteromechanophobia (fear of flying), if any of us have not experienced a long haul flight together with its numerous vagaries.

The strategic astronaut's first big picture: a view of the airline industry within the global economy

It will be useful to take your Examiner's advice and research the airline industry setting to assist in understanding the problems and opportunities facing Flyqual. Using this awareness to discuss the main issues will score marks specifically within the “diversity” criterion and will enhance the quality of discussion in relation to all the other criteria. Business awareness will also prevent you from making unrealistic comments and will enhance the commercial and professional judgement that you display throughout the report.

It would be foolhardy to try to find the one company that “fits” Flyqual's position and circumstances. TOPCIMA cases are necessarily not written that way. Of course, one cannot ignore echoes of Singapore Airlines’ global reputation for quality and excellent service having like Flyqual, established itself just after the Second World War, listed on its Asian home base stock exchange and owned mainly by large companies. You also cannot ignore echoes of the problems BA faced when over 100 flights had to be cancelled during the peak summer season of 2005 when its ground staff went on unofficial strike in support of Gate Gourmet (outsourced supplier of BA’s catering) staff who had been sacked. The disruption was estimated to have cost BA up to GBP 40 million, with further damage to its reputation. This was the third consecutive summer that BA passengers had experienced severe disruptions due to industrial action.

We found that doing a search entering key words in the search engine Google (sorry, the single word verb that describes this process is now legally patented and protected by Google) produced some very useful industry information. For example, entering “airline industry” produced a list which included the Wikipedia free encyclopaedia site
http://en.wikipedia.org/wiki/Airline with the following table of contents links:

- 1 Industry overview
- 2 Patterns
  - 2.1 World's First Airline
  - 2.2 Early development of airlines in the U.S.
  - 2.3 Early development of airlines in Europe
  - 2.4 Development of airlines post-1945
- 3 Regulatory considerations
  - 3.1 Government regulation
  - 3.2 International regulation
- 4 Economic considerations
- 5 Customs and conventions
- 6 Airline personnel
- 7 Special airlines
- 8.1 Lists
- 9 External links
- 10 References

Clicking on the first link in the contents, "Industry overview" gave information and explanations on:

- The changing pattern of ownership has gone from government owned or supported to independent, for-profit public companies as regulators permit greater freedom.
- The derived economic demand factors that air travel services are dependent on.
- The overall trend of demand - consistently increasing.
- The cyclical nature of the industry.
- What Warren Buffet once said, that despite all the money that has been invested in all airlines, the net profit is less than zero. He believes it is one of the hardest businesses to manage.
- The trend, as in many mature industries, towards consolidation.

The detailed information presented portrays, amongst other things, an industry where margins are negligible and risks very high, long-term investment does not generally increase shareholder wealth, investment in new technology takes place in profitable times, and consolidation in the form of alliances, takeovers and mergers is a common trend. Immediately, this gives a crucial insight into the nature of the industry and a host of strategic issues that a company such as Flyqual is likely to deal with or consider.

Each link from the above table of contents provided essential details of exactly the environment that Flyqual is operating in and the "Economic considerations" link gave examples of the impact on specific airlines from strategic decisions to invest in certain types or mix of planes whilst the "Special airlines" link helped us to home in on Singapore Airlines and BA, amongst many others - a great beginning to our research.

More specific searches such as, for example, "cost of BA and Gate Gourmet strike" which took us to a link http://www.eiro.europa.eu/2005/09/feature/uk/0509106f.html and produced gems such as: "Whether or not the company is guilty of what Tony Woodley, the general secretary of the TGWU, called 'crude union-busting techniques', the episode does suggest that confrontational 'macho management' is alive and well in the UK."
First, this reflects a more aggressive commercial environment; in this case, BA was able to squeeze a supplier that was largely dependent upon it in order to help meet its own longstanding cost-cutting programme. Mr Woodley referred to 'bogus' outsourcing as a 'legal nicety' to permit cost-cutting and productivity measures at the expense of working conditions. BA is now one of the world’s most profitable airlines, with first quarter pre-tax profits of GBP 124 million, though the logic of outsourcing where the commercial relationship is mutually dependent was also brought into question by the dispute.

Second, a hard-line management style is also facilitated by UK labour law. Obligations to consult systematically are limited, and significant restrictions are placed on industrial action. Employers are permitted (after 12 weeks of industrial action) to dismiss strikers for breach of contract ...

Clearly there is some similarity to the information in the pre-seen when, under “Managerial Style of FQA”, it talks of the strong tactics employed by the directors of FQA and many difficulties it has faced with suppliers, particularly its outsourced catering service at its home based airport in the capital city.

We believe it is important to remember that FQA is a fictitious case- it isn’t Singapore Airlines (although the case organisation's home base in Asia) or BA (even though the staff and catering situation is similar); and it will take industrial and organisational contexts from different parts of the world.

The strategic pilot's cockpit instruments to help navigate the turbulence in Flyqual's path.

The context and case data determines which technical tools (strategic analytical models) and performance measures, in addition to critical common sense, are most useful in identifying and applying “knowledge” (a specific requirement across four of the assessment matrix criteria) as well as coming up with a range of alternative solutions (necessary to score well in the “Judgement” criterion). In management, you often get the right answer by starting with the right question.

How does Flyqual compete?

Applying Porter's generic strategies, FQA has clearly been implementing a differentiation strategy and avoiding a low cost approach. The pre-seen case makes it clear that “as the name implies, FQA prides itself on providing a first rate passenger service and enjoys a strong reputation for quality service to passengers...Some airlines offer services at both the high quality and the basic 'with no extras', so called 'low-priced' or 'no frills' end of the market. FQA has chosen services at the high quality end of the market only.”

A significant aspect of FQA’s differentiation strategy is its membership of the N aviation alliance that substantially enhances the benefits and choices to its customers. Established long-haul airlines such as Singapore, Cathay Pacific, BA and Qantas have a similar strategy to Flyqual and are challenged by later entrants who offer comparable quality, such as Qatar, Thai and Emirates, very often at a lower price supported by location based factor advantages.

To understand what differentiators are valued by customers and therefore what they will pay a premium for, it is interesting to note that industry awards are often based on surveying the “best” airline including “best” cabin staff; “best airports”; “best lounge” (business and economy); “best” in-flight entertainment; “best” catering (economy, business and first class); “best” leadership (individual award); and “best alliance”. However, there is nothing more glaring than first hand
experience. One of this article's authors has flown for business and pleasure on airlines as diverse as BA; Qatar; South African Airways; Brunei Royal Airlines; Air Zimbabwe; Emirates; Lufthansa; Jet; Virgin; Ryanair; Easyjet; Air Mauritius; and Croatian Airlines. Having experienced being non-existent (“I can see your computer printout from your agent, but according to my system, you’re not booked”); lost luggage; luggage contents stolen; cancelled flights “owing to a technical fault”; delays because “the pilot is stuck on the motorway”; violently drunk passengers; rude cabin crew; and flight diversions to airports other than the final destination, the author would gladly opt for the airline that has a track record of generally the least such incidents and would be willing to pay more for certain essentials on a long haul flight such as good meals; great entertainment on demand; punctuality; wider seating and more leg room; perfectly controlled humidity; efficient check in; good convenient airport facilities including lounges; and a track record for safety and positive response to incidents - but perhaps I’m too fussy!

One item on FQA’s scorecard that stands out amidst the competition data provided is that its punctuality record (on time departures within 15 minutes) is at least 17 percentage points higher than the two competitors. “One area of which the Board is particularly proud is FQA’s reputation for being one of the most punctual and safest airlines in the world”.

In a service oriented industry, apart from a classically attractive marketing mix of the 4 Ps, an additional 3 Ps become more important – people, physical evidence (how will you show potential customers the quality of your service?), and process (processes should do more than just make life easier for you, they must help your customers get what they want and could new systems or new technology help you stand out from the competition?). FQA may have established its physical evidence in terms of brand perception with customers, but it faces serious challenges in sustaining its quality based differentiation strategy. The two largest shareholders are highly critical of their running costs and FQA’s leadership has responded with the view that reducing staffing levels is the only solution to lowering costs whilst acknowledging the likely negative impact on staff morale, quality and therefore, ultimately, market share.

Looking at the stats on FQA’s fleet of aircraft, if the whole fleet is flying at any one time, on average each member of FQA’s global staff employed is serving 3 to 4 proverbial “bums on seats”. Whilst this may be excessive, there is an abundance of evidence highlighting what Maslow’s and Herzberg’s theories on motivation would classify as demotivation as the basic, lower level needs (hygiene factors) of adequate pay, good working conditions and job security are not being met. This is within the backdrop of a highly unionised workforce generally prepared to react with strong arm tactics matching FQA’s tough human resource management style. FQA management’s employment of strong cost reduction tactics extends to its outsourced catering service supplier CG. As pointed out earlier, similar tactics by BA resulted in huge losses from industrial action over the years culminating in the wild cat strike by its staff in favour of sacked Gate Gourmet (its outsourced catering service supplier) workers. The disruption and cancellation of scores of flights in peak summer season severely dented BA’s former reputation publicised by its previous slogan of being “the world’s favourite airline”.

A rational approach to strategic management would suggest that Flyqual’s management clarify and get agreement on its strategic direction, mission and objectives through effective stakeholder analysis and management. The global consultants McKinsey have suggested an approach that begins by investing in investor relations to manage shareholders' perceptions to bridge the gap between the market value and the potential value of the business.

The board has more non-executive than executive directors creating a platform for good governance, and FQA’s overall strategy has probably made the majority shareholders, the
unions, executive management and outsourced suppliers all “key players” in relation to that strategy. Mendelow's stakeholder mapping matrix which analyses stakeholders in terms of their interest in and power over an organisation's strategic direction is clearly useful here. A highly participative stakeholder management process supported by intensive, transparent communication would be the rational approach in the circumstances.

Further challenges in sustaining a differentiation strategy are posed by the need to make the right decision in the choice of replacement aircraft. Analysis of the case discursive data to sustain the highest level of differentiation suggests FQA may need to replace its fleet with mainly F 898 aircraft which have smaller capacity but greater destination flexibility and passenger convenience (Interestingly, as demonstrated later, the option with the lower NPV!). Of course, an “optimum” mix of the two types of aircraft is an alternative worth considering. Strategic marketing and financial research and analysis would help with this decision in terms of expected demand, competition, fuel costs, and staff re-training and operational costs. Shifting towards a cost based strategy would definitely clash with Flyqual's whole culture and ethos established over many years on the back of a differentiation strategy.

The source of competitive advantage for an organisation is an appropriate collection of strategic assets, capabilities and competencies — and although they are under threat, Flyqual has evolved an appropriate value chain to ensure that they are used together effectively to provide some distinctiveness in the eyes of the customers.

**Turbulence: What are the competitive forces in the airline industry?**

You will find the Porter's five forces model is useful to analyse the competitiveness, level of profitability and attractiveness of an industry and the firm's competitive position within the industry. A full five forces analysis in detail is outside the scope of this article, but we will look at just one of the forces, the threat of entrants. In the air travel business as operated by the traditional airlines, the barriers to entry have been relatively high because of high capital costs of aircraft; regulation of routes and landing slots has restricted access; government affection for, and ownership of, national flag carriers; and the restrictions on airport services.

The high risk and relatively low margins have made investment unattractive and the high costs of entry make exit equally onerous. In spite of this, new direct competitors such as Qatar and Emirates, financed by wealthy governing Arab “oil sheiks” have successfully entered late into the market and built up an enviable reputation of quality with value for money offerings within proximity of Flyqual’s home base.

Looking at budget “no frills” as opposed to traditional entrants, Virgin Atlantic is holding talks with an Asian airline about setting up a global carrier that could offer flights from Britain to Malaysia for less than GBP50. Reports suggest that Sir Richard Branson, the Virgin chairman, is looking to team up with Air Asia, a Malaysian low-cost airline, to open up the fast-expanding Asia region to low-cost flights from Britain.

Another new entrant, Oasis Hong Kong Airlines, which has been granted licences for services to London, Berlin, Cologne, Milan, Oakland and Chicago, now needs an air operator's certificate from HK's Civil Aviation Department. Initially, it plans to lease five Boeing 747-400s but has a five-year plan to serve up to 15 destinations with a fleet of 25 aircraft. On the London route, it aims to undercut rivals, such as Cathay Pacific, British Airways, Qantas and Virgin Atlantic with fares 40% to 50% lower, attracting what it predicts will be a new market of long-haul travellers. It also plans to offer a budget Business class for those who want more than just the basics.
There is no doubt that Porter’s “diamond” model analysing the national competitive factors that create global “winners” would point to Flyqual enjoying location based advantage with its home base in Asia. Amongst other things, it would enjoy source of quality labour, a culture of customer focused service, and low factor costs. The case notes that FQA's positive reputation “has given rise to national pride and the government has provided financial support in terms of grant and loans particularly in regard to a new terminal development at the capital city in FQA’s home country”. Very importantly, they are in proximity to high growth demand, in terms of passengers as well as high value, high technology cargo, of the largest consumer markets over the next two decades, namely China and India.

China is often referred to as the “joker in the pack” because of the sheer scale when unlocking domestic demand to create global economies of scale, even for luxury products. Rampant demand for luxury cars among China’s new rich is rapidly making the country the biggest growth market for iconic carmaker Rolls-Royce. Sales are up 50% this year, the firm says, with Beijing tycoons taking delivery of a US$2.2m stretch limousines. Corporations in China spent US$7.41 billion on air travel in 2005, making China the fourth biggest business travel market in the world, according to the results of American Express Business Travel’s China Business Travel Survey. Airbus identified China as the fastest growing outbound tourism market on the planet. Flyqual would be in a strong position to pick up a significant share of this growth in the premium priced sector.

Where does Flyqual compete?

As clear as FQA’s generic strategy of differentiation has been, its focus on products and markets is less clear. The case data points out that “FQA does undertake some short-haul schedules in the Asia-Pacific region, but its principal business is in long-haul intercontinental flights to the USA and Europe”. However, a quick calculation around the data on FQA’s fleet of aircraft shows as much as one-third of the total fleet seating capacity is mainly used on short-haul routes. FQA also holds a 45% stake in a smaller airline outside the alliance engaged mainly in short-haul scheduled and cargo flights around the Asia-Pacific region. Could this be a clue for the future?

In deciding on its fleet replacement policy, there is the possibility of Flyqual evaluating the impact of concentrating more on long-haul traffic where differentiators become more important and reviewing its return from the stake in the smaller airline. A useful feature of the C 491 aircraft is an on board medical site, a product service enhancement that would appeal to older passengers, particularly as the demographic profile of passengers shifts more markedly to the Saga Travel type of niche market exclusive to over 50s, or as the marketing gurus call them, the “woofs” (well-off older folks) or “wrinklies and crinklies”.

You can consider using Ansoff’s growth vector matrix to identify product market options, existing and new. You need to consider evaluating such options using Johnson and Scholes’ SFA (suitability, feasibility and acceptability) model for evaluating the viability of a strategy.

Finally, no analysis of the pre-seen would be complete without some financial review and a bit of crystal ball gazing as they can provide extra insights into the direction that the unseen may take.
Some Initial Quantitative Analysis

Valuations

- Market capitalisation: $520m × $9.0 = $4,680m
- Asset value: $3,948m
- Present Value of Earnings: $371m × 1/0.10 = $3,710m if no growth

Based on an initial review, there do not appear to be any issues here; market capitalisation seems to be reflecting a level of expected growth which may be reasonable given the growth achieved between 2005 and 2006.

Competition data
(SIA = Singapore Airlines, ANZ = Air New Zealand, BA = British Airways)

<table>
<thead>
<tr>
<th></th>
<th>FQA</th>
<th>Comp 1</th>
<th>Comp 2</th>
<th>SIA</th>
<th>ANZ</th>
<th>BA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit / Revenue</td>
<td>3.4%</td>
<td>3.1%</td>
<td>3.3%</td>
<td>9.8%</td>
<td>2.5%</td>
<td>5.5%</td>
</tr>
<tr>
<td>P/E</td>
<td>12.6</td>
<td>12.1</td>
<td>9.4</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Gearing (D/E) using MV</td>
<td>90%</td>
<td>97%</td>
<td>123%</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Km flown per aircraft</td>
<td>3.3m</td>
<td>3.2m</td>
<td>2.9m</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Load factor</td>
<td>80%</td>
<td>75%</td>
<td>73%</td>
<td>76%</td>
<td>75%</td>
<td>76%</td>
</tr>
<tr>
<td>On time departures</td>
<td>93%</td>
<td>76%</td>
<td>75%</td>
<td>?</td>
<td>?</td>
<td>75%</td>
</tr>
</tbody>
</table>

So FQA appears to be superior to competitors 1 and 2 in all areas. Could FQA be planning a takeover over one of these operators? If so, which would you recommend?

The industry information suggests that higher margins are possible but is the information comparable? What other information can you find? How does it help?

Analysis of accounts

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
<th>SIA</th>
<th>ANZ</th>
<th>BA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Profit %</td>
<td>7.0%</td>
<td>4.4%</td>
<td>9.1%</td>
<td>3.9%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Net Profit %</td>
<td>3.4%</td>
<td>1.5%</td>
<td>9.8%</td>
<td>2.5%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Return on Equity</td>
<td>9.4%</td>
<td>4.2%</td>
<td>9.2%</td>
<td>6.0%</td>
<td>22.5%</td>
</tr>
<tr>
<td>Current ratio</td>
<td>0.85</td>
<td>0.83</td>
<td>N/A</td>
<td>1.09</td>
<td>1.07</td>
</tr>
<tr>
<td>Gearing – Book Value</td>
<td>107%</td>
<td>103%</td>
<td>17%</td>
<td>101%</td>
<td>174%</td>
</tr>
</tbody>
</table>

*Note: Debt figure used includes leases*
Profit percentages are increasing on back of a 7% increase in revenue, presumably the result of the high fixed cost base (Staff, Fuel, etc). Profits may be adversely affected by increased fuel costs in 2007 as discussed below.

Current ratio less than 1 but how much power do suppliers have to create problems for FQA? Where is the balance of power in the relationship? Notice that others in the industry have ratios around 1.  
*Note: The pre-seen information gives no breakdown of current assets or current liabilities.*

Gearing is lower than competitors 1 and 2 but is significantly higher than SIA. Other airlines also have a high gearing level which may be surprising given the high fixed cost base prevalent in the industry. What is the impact of this?

**Cost structure**

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2005</th>
<th>SIA</th>
<th>ANZ</th>
<th>BA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Staff</td>
<td>21</td>
<td>21</td>
<td>16</td>
<td>?</td>
<td>30</td>
</tr>
<tr>
<td>Fuel</td>
<td>30</td>
<td>29</td>
<td>35</td>
<td>30</td>
<td>21</td>
</tr>
<tr>
<td>Landing</td>
<td>10</td>
<td>9</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
<tr>
<td>Other</td>
<td>39</td>
<td>41</td>
<td>?</td>
<td>?</td>
<td>?</td>
</tr>
</tbody>
</table>

Although the % of total expenses does not appear to have moved significantly there is a noticeable change in fuel expenses. Fuel prices have been a major influence on profits within the industry:
- SIA reported a 57% increase in fuel prices in their accounts y/e March 2006, and a 32% increase in the 6 months to September 2006.
- ANZ reported a 44% increase in fuel costs in 2006 and warned of another $350m (37%) rise in 2007 which will have a dramatic impact on profits.
- BA said that fuel has risen by 45% in their 2006 accounts.

This doesn’t seem to be reflected in FQA’s figures presumably due to the hedging techniques used but fuel prices are likely to be higher in 2007 (when the fuel hedges end) which could have a significant impact on 2007 profits.

**Discounted Cash Flow (DCF) on New aircraft**

A fairly straightforward DCF computation from the pre-seen data gives the following NPV for these aircraft: F 898 +$26m per aircraft, C 491 +$97m per aircraft.

C 491 is clearly preferable from a NPV point of view but could be considered to be the riskier option due to the need to transfer to other flights from “hubs” and the requirement for new infrastructure at airports, notably new runways and airport gates. Also, these “super jets” have only just been introduced into the industry and may take time to become accepted by passengers and other key players within the airline industry.

FQA would also need to consider the other factors listed in the pre-seen such as expected
demand, competition and additional costs, so the decision may not be clear cut.

**Lease or Buy decision**

Another standard calculation using DCF techniques shows that the Buy decision is preferable for both aircraft (F 898 by $45m per aircraft, C 491 by $46m per aircraft) but purchasing does require considerable capital investment that FQA may not be able to afford (as discussed below).

Given the low level of cash flow that seems to exist in FQA (assuming profit equals cash flow), leasing might still be the preferred option even though will cost about $45m extra (in NPV terms) per aircraft - an interesting need for "judgement" to be exercised.

**Repayment of loans**

FQA has a loan of $1,000m due for repayment at the end of 2008 and another $1,000m loan due to be repaid at the end of 2009. Given their current profitability it is unlikely that FQA will have cash available to repay these loans unless new finance is raised. New finance will also be needed to replace its ageing aircraft.

**Raising finance**

If we assume that FQA need 10 new planes, then they will need $2,500m if they buy C 491s or $1,500m if F 898s are acquired. In addition they will need $1,000m in 2008 to repay a loan.

**Equity finance**

- Flyqual's context as a public listed company with majority shareholdings in the hands of two large conglomerates is important to understand - will they be willing to invest more? Why would / should they?
- Return on equity is 9.4% which is barely above the cost of loans so may suggest that FQA is not a suitable investment prospect.
- Revenues increased by 7% last year, which led to a 136% increase in profit. This may lead potential investors to believe that FQA has a positive future. Would you support this view given your knowledge of this company and its industry?

**Debt finance**

- FQA has $8,408m of non-current assets. With only $4,220m of long term liabilities this would suggest that FQA has assets to offer as security but most of those assets may be aircraft which are not necessarily a suitable security.
- Gearing appears high at 90% (by market value) given the high fixed cost base prevalent in the industry but is below competitors 1 and 2. We have already identified that high gearing is not unusual in the industry - why is this? What are the implications for raising debt?
- Interest cover
  - At 30 September 2006 = 2.87 (operating profit of 760 / financing cost of 265)
  - Assume $2,500m borrowed ($1,500m for F 898s + $1,000m for loan repayment).
  - Interest at 8% = $200m pa
  - Interest cover would become 760 / 465 = 1.63 assuming profit unchanged
  - This is on the low side especially given the volatile nature of the industry.
As already stated, FQA does not have a significant surplus cash flow but on the assumption that profit equals cash flow, FQA should have enough to cover the additional interest.

Given the above, it may seem logical to acquire the new aircraft using leases, and raising finance from the shareholders (if possible) to repay the loans.
You may have other ideas!

The Crystal Ball - Potential problems and proposals in the unseen

The exam day unseen material and requirement will expect you to engage a wider range of new and pre-seen strategic issues and proposals, albeit related to the above broad strategic issues. It would be prudent to, amongst other things, be prepared to engage the following potential matters that could arise in the unseen material:

Exacerbation of existing problems or proposals

- Impact of rising fuel prices especially when existing fuel hedges end
- Which aircraft to choose
  - F 898: Flexible; Less capital required; Smaller capacity
  - C 491: Higher NPV; Logistical problems; Less cabin staff needed; Will customers want this new “hub based” travel idea?
- Lease or buy new aircraft?
- Air cargo - a possible growth area
- Strike action by staff
- Catering problems (e.g. BA’s Gate Gourmet)
- Pressure from shareholders to reduce costs
- Cash flow / financing problems

Possible problems and proposals/unseens

- Expand operations in Asia - Pacific
- Acquire rest of subsidiary
- Dispose of subsidiary
- Expand short haul operations
- Problems re supply of new aircraft (e.g. Airbus which Boeing took advantage of)
- Acquire airport authority in home country
- Acquire a competitor
- Bid to acquire FQA by a competitor
- Environmental issues - emissions etc
- Introducing a budget “no frills” airline, short-haul and long-haul
- Problems with alliance partners
- Reduction in demand owing to economic factors or terrorist action
Fasten your seat belt and prepare for a safe landing

We now refer you to the article (designed to teach you how to handle any pre-seen, assessment matrix and unseen rather than duplicating full blown analyses), “Riches to Rags” by Shuaib Masters on the last pre-seen which gives clear advice, directly from him and from your Examiner, on preparing you to pass TOPCIMA at
http://www.cimaglobal.com/cps/rde/xbcr/SID-0AAAC544-1D80A564/live/topcima_article_richestorags_nov06.pdf particularly the sections headed

• Arranging the toolbox for the context
• Targeting the matrix
• Ethics, the dead cert
• Strategic competencies plus practice plus technique equals confidence to pass

as the advice is still highly relevant, and we believe absolutely crucial, to managing the current pre-seen and related coming unseen. Note that the assessment matrix remains the same for this case.

Finally, Muhammad Ali, the great boxer, is reported to have quipped to one of the cabin crew that “superman does not need a seat belt”. The crew member's response was "superman does not need a plane to fly!"

_Bon voyage!_