

“FLYING HIGH”

or

The Successful Take-off of airBaltic

Abstract

This is a case study of a Latvian airline airBaltic that despite the tough characteristics of the airline industry has been able to grow steadily and compete side-by-side with the aggressive low-cost competitors. We explore how the company has managed to transform from a full service airline with a home base in a small and unrecognized destination to a competitive hybrid carrier that is able to follow the industry price pressure by simultaneously expanding its route network and uncovering the hidden potential of the market.

The main purpose of this thesis is to identify the critical factors behind the successful development of airBaltic. During the two stage analysis, based on Porter Five Forces and Resource Based View of Strategy, we have identified several success factors. The Rolling stage with its weak market competition, government support and strategic partnership with SAS formed the competitive base for airBaltic, and allowed the company to meet the fierce competition during Take-off stage which came with substantial market changes and required flexibility and solid base of experience in order to be able to compete with the aggressive low-cost carriers. The route network developed during the Rolling stage served as a strong weapon for airBaltic in this competition.

We believe that our thesis will give researchers additional insight of how reconciliation between outside-in and inside-out perspectives in strategy formulation can be reached, and inspire managers of small regional airlines to use their potential and follow the market changes.

Keywords: airBaltic, “Open Sky”, outside-in perspective, inside-out perspective, resources and capabilities, airline industry.

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1 Introduction

This section presents the background of the thesis topic and explains to the reader why this phenomenon is interesting to study. The purpose of the thesis is briefly formulated followed by a description of how the thesis contributes to the research area. Finally, the thesis outline is presented in order to facilitate the reading process.

1.1 Background

Airline industry has always been attracting a great deal of attention of researchers and practitioners due to its particularity. It is an industry characterized by cyclical nature, very thin profit margins, tight regulations and fierce competition. Huge capital investments are required in order to ensure a sufficiently steady foundation for the start of the business. Recently the European airline industry has been experiencing several challenges that have turned around the market trends and changed the prevailing business practices of the operating airlines. One of the most important challenges faced by the European airlines is the “Open Sky” regime which since 2004 has created a single unified large market for air transport consisting of the twenty-five member states of the European Union plus Iceland, Norway and Switzerland. In 2007 two more countries joined the EU, and the unified market now encompasses twenty-seven member states. As a result, both traditional legacy carriers and low-cost airlines have been lumped into one big bowl, and the competition has intensified to a large extent. The low-cost airlines are making a big pressure on the traditional airlines by constantly lowering ticket prices and intrusively penetrating the market with ever new routes.

Despite the threatening description of the industry, there are several airlines that have discovered the secret survival algorithm and been able to successfully compete in the market. Furthermore, even seemingly inexperienced and small airlines have found the right place on the earth and fearlessly come up against the “big brothers”. Obviously, a curious question arises: What lies behind their success? What is the magic formula of success in such a thankless industry?

We got impressed by airBaltic. A new airline started its operations in Latvia in 1995 and wakened a market that had fallen asleep during the early years of Latvia’s independence. By gradually accumulating the market knowledge and learning from the experience of the well-

known Western airlines, airBaltic revived the market and attracted interest of foreign airlines to Riga as an interesting destination. Although being a relatively small and new airline in the common EU airline market, airBaltic has an advantageous niche which allows it to enjoy the benefits of the rapid economic growth in the Baltic States and to adapt to the changing business practices brought in by an increasing amount of competitors. We consider airBaltic as a success story and as an example of how a small airline can find an advantageous niche in the market and gain the largest market share in Riga airport by constantly expanding its route network and the number of passengers. By gradually accumulating its strengths, airBaltic has been able to successfully deal with such a rapid turnaround of the industry as happened in 2004.

Critical factors behind the successful development of airBaltic are identified with the help of both outside-in and inside-out theoretical perspectives. We have an ambition to integrate the Five Forces of Competition Model with the Resource-based View of Strategy in order to see that the company's strategy is a reconciliation of its internal factors and the external environment.

We believe that our thesis will be of interest to both researchers dealing with analysis of external and internal environment of a company, and practitioners engaged in the airline industry. For the former, we want to pay attention to the factors that are of crucial importance when analyzing a newly-developed company in an environment of an evolutionary increasing competition. For the latter, we have an ambition to give an inspiration of how small regional airlines could use their potential to gain a strong position in the market. This report could be of special interest to other airlines with a home base in the Baltic States due to similar historical conditions and a comparable geographical location as Latvia.

1.2 Purpose

The purpose of the thesis is to identify the critical external and internal factors that explain the successful development of airBaltic.

1.3 Contribution

The main contribution of the thesis is its attempt to find reconciliation between outside-in and inside-out perspectives that create foundation of a specific strategy pursued by a

company. It also specifies the main factors that should be paid attention to when analyzing development of a company throughout a period from a low level to a fierce competition.

1.4 Outline of the Thesis

The first section just introduced the reader with the background and purpose of the thesis. In the second section the chosen methodology is described, followed by theoretical background in the third section. A description of airBaltic is presented in the fourth section, and an analysis of airBaltic follows in the fifth section. Section six draws the conclusions, and finally, section seven presents propositions for future research.

2 Methodology

This section introduces the reader to the research method used, the reasons behind selecting the case of airBaltic, delimitations of the thesis, and the process of data collection. Finally, it discusses the results of the research.

2.1 Research Method

This thesis is a *qualitative* research since the data that were required according to the purpose of the research could not be collected in a standardized way like quantitative data (Saunders et al., 2003). Since we only had a modest insight of what the critical factors behind the success of airBaltic were, we were not able to collect the data in a structured way. The process of data collection was rather interactive when the collected data initiated new questions and further data search. Therefore, interviews and observations were considered to be the most appropriate methods for the data collection.

Research Design – Exploratory

Due to the purpose of the thesis we have chosen to follow the *exploratory* research design. It is considered appropriate when the research problem is not fully understood, but the author has a priori suspects/hypotheses (Ghuri and Grønhaug, 2005). Furthermore, as more new information is obtained, the path towards the answer could change its direction. During the early stage of our research, we were impressed by the rapid expansion of airBaltic, but could not fully guess the factors which lied behind its success. Therefore, our aim was to *explore* the development of the company and the critical external and internal factors that influenced its strategy. Although our initial suspects were that the main advantage of airBaltic was the transit business, the information that we gathered changed our guess and put the focus on other factors.

Research Approach – Inductive

There are two approaches which can be used when conducting research: deductive and inductive. The former is defined as testing of a theoretical proposition by building hypotheses from the existing theory and empirically scrutinizing in order to accept or reject them (Saunders et al., 2003; Ghauri and Grønhaug, 2005). Inductive approach, on the other hand, is “the systematic process of establishing a general proposition on the basis of observation or particular facts” (Ghuri and Grønhaug, 2005, p. 16). We are using the inductive approach

since we are interested in understanding why airBaltic has been so successful. Thus, we start with an observation of the company and proceed by looking at how the chosen theories help us to understand the critical factors behind the company's success. After that we reason what the theories did not manage to uncover and, thus, what our proposition regarding the applied theory is.

Research Strategy – Single Case Study

During our thesis we try to answer *how* and *why* questions because our aim is to explore the critical factors behind the success of airBaltic. Consequently, a case study approach is considered to be the most appropriate, and is used in this thesis. In our situation, it is crucial to take into account the contextual conditions, which, according to Yin (2003), are best covered by the case study. Furthermore, our research is a single case study because we consider airBaltic as a unique case worth investigating. We did not see any similarities in terms of pursued strategy and historical and market conditions in order to compare airBaltic with another company.

2.2 Case Selection

The path towards our thesis topic and airBaltic as a research object was gradual but straight. We both are Latvians who coincidentally met at the Stockholm School of Economics and decided to write the thesis together by using our knowledge of the Latvian economy. Airline industry was a logical choice. One of the thesis authors has been involved in it already from the childhood because all of her family members were in one way or another engaged in the airline business. We still remember the resent times when only the most well-off people could afford the airline services, and a few airplanes departed from Riga airport during a day. Today, when standing at the window of Riga airport even for a while, brightly green-coloured airplanes are departing one after another in small intervals. Brightly green is a corporate colour of airBaltic. We both are impressed by the rapid expansion of airBaltic and ever increasing opportunities of Latvians to reach different business and holiday destinations. The most astonishing fact that rouse our interest was the company's transition from a full service airline with a home base in a small and unrecognized destination to a competitive hybrid carrier that is able to follow the industry price pressure by simultaneously expanding its route network and uncovering the hidden potential of the market. Therefore, airBaltic is interesting because of its flexibility in adapting to changing market conditions. airBaltic plays an important role in facilitating the development of Latvian tourism industry, since due

to the company's services an ever increasing amount of tourists can easily reach Latvia. Naturally, we were very curious to explore how and why this has happened.

2.3 Delimitations

During our thesis we are using only one theoretical proposition for outside-in and inside-out perspectives: Five Forces of Competition and Resource-based View of Competition, respectively. We think that both theories fit together well and cover the majority of aspects that can explain the pursued strategy of a company. Furthermore, it allows us to make a deeper analysis of the external forces and internal resources and capabilities that shape the company's strategy. Only, in our opinion, the most important influential factors have been identified.

We have excluded a deeper analysis of the company's operations, management style and structure, among others, that could give a more comprehensive picture of the situation within the company. Financial analysis has been excluded as well, since we were not able to access any financial information than just the publicly available. Although airBaltic has two home bases (Riga and Vilnius), we focus on airBaltic in Riga, since the Vilnius base was opened only recently (in 2004), and the strategy of airBaltic has different particularities in each base.

2.4 Data Collection

There are two sources of data: *primary* and *secondary* data. The former are the original data collected by researchers with a particular aim in mind, and usually include observations, experiments, surveys and interviews. The latter consist of information collected by others for purposes that can differ from the researcher's purpose, and include books, journal articles, online data sources and others (Ghauri and Grønhaug, 2005).

Primary Data Sources

The main primary data source we used was *interviews* since they allowed uncovering details that could not be directly observed (Yin, 2003). It was important for us to hear the interpretation of the respondents about the strategy pursued by airBaltic. In spring 2007 an initial draft of the questions of interest was prepared and a personnel manager of airBaltic was contacted via e-mail and phone in order to introduce our idea and ask for the possibility to cooperate with the company. Our initial guess was that we should meet with the top-level managers, since our research topic concerned strategic issues dealt by the top-level

management. However, the personnel manager took the responsibility of finding appropriate respondents based on our draft of questions. After discussions with the company's management team, the personnel manager scheduled meetings with the Chief Financial Officer (CFO) and Chief Commercial Officer (CCO). A month later we met the Chief Executive Officer (CEO) of airBaltic in order to discuss the issues under his direct responsibility, and specify the information collected during the previous interviews.

All of the interviews were made at the head office of airBaltic in Riga during June-July 2007, and lasted for approximately two hours each. Both of us were present in all interviews which helped us to better interpret the interviews and reduce the bias. A list of questions intended to be asked were e-mailed to the personnel manager and later forwarded to the respondents a week before the interviews. We mostly used the same questions to all respondents, although some questions were different. Although the interviews were conducted in Latvian (except for the one with the CCO), an interview protocol was prepared in English after each interview and sent to the respondent for verification. The quotations used in the thesis are translations from the original Latvian responses. We used semi-structured interviews where the main questions to be asked and people to be interviewed had been determined beforehand (Ghuri and Grønhaug, 2005). This allowed us to decrease the bias but at the same time leave room for unexpected discussions around the topic. The questions that we asked mostly concerned among others the evolution of the strategy of airBaltic, its ability to deal with the increasing competition, the main advantages of airBaltic, and the role of the government.

Another interview that we carried out at the beginning of July was with the director of the Aviation Department of the Latvian Ministry of Transport. Our initial guess was that the Latvian government has a large influence on the strategy of airBaltic, and therefore we were curious to find out what the truth is. The interview was in Latvian, and we followed the same procedure as discussed previously. In this case, the main questions we discussed concerned the support of the government to airBaltic, and its interests. A summary of the conducted interviews can be seen in *Table 1*.

Table 1. Summary of the conducted interviews.

Respondent	Date	Duration
Jan Lundborg, CCO of airBaltic	Jun 27, 2007	2 hrs
Mārtiņš Antonovičs, CFO of airBaltic	Jun 27, 2007	2 hrs
Arnis Muižnieks, director of the Aviation Department of the Latvian Ministry of Transport	July 2, 2007	2,5 hrs
Bertolt Flick, CEO of airBaltic	July 25, 2007	1,5hrs

Another primary data source that we used was *direct observations*. Although the observations were informal, they helped us by providing additional information about the topic (Yin, 2003). First, both of us were frequent travellers between Riga and Stockholm and thus loyal passengers of airBaltic. The service encounter allowed us to directly observe what kind of and how the service is delivered. Second, there were constant discussions with two family members of the thesis author (both currently working for airBaltic, and one working for airBaltic since its establishment) about their experience of the company's development.

Secondary Data Sources

In order to complement the primary data, we have used such secondary data sources as journal and newspaper articles, available annual reports of airBaltic, the company's monthly newspaper Baltic Outlook (available online since October 2003), and airBaltic press releases starting from 1998. Furthermore, annual reports of Riga airport and other Internet sources were used. All of them allowed us to get a better understanding of our research topic and get some statistical data of the development of the Latvian airline industry and airBaltic. Journal and newspaper articles, as well as other Internet sources allowed us to take into account a different and more critical viewpoint about airBaltic.

2.5 Quality of Research

There are two main ways of assessing the quality of research: assessment of *validity* and *reliability* (Saunders et al., 2003).

Validity

According to Saunders et al. (2003), validity is "the extent to which research findings are really about what they profess to be about" (p. 492). Three forms of validity can be measured by a researcher: *construct*, *internal* and *external* validity (Yin, 2003). Construct validity refers to the usage of a sufficiently operational set of measures that are appropriate to the

purpose of the research. In order to increase the construct validity, we used multiple sources of evidence, such as interviews, annual reports, observations, journal and newspaper articles, and airBaltic press releases starting from 1998 that are available on airBaltic webpage. All the collected data were compared and evaluated. Furthermore, the thesis was revised by the representatives of airBaltic.

Internal validity refers to the extent to which the results obtained within the study are true (Ghauri and Grønhaug, 2005). The usage of the previously mentioned primary and secondary sources, as well as the revision of the thesis by airBaltic representatives should increase the internal validity of the thesis. Although the relationship between and causes of the different critical factors identified were more our own interpretation, the thesis should give a good overall evaluation of the development of airBaltic. However, some other influential factors and aspects could have been ignored by the thesis.

External validity shows whether findings of a research can be generalized beyond the specific case study (Yin, 2003; Ghauri and Grønhaug, 2005). airBaltic has been chosen as a unique case which makes it difficult to apply the findings to another context. The critical factors of each company's success differ and cannot be taken out of the specific contextual settings. However, the factors identified in our thesis could be paid attention to when examining another airline in a growing economy. Perhaps, the results could be useful when analyzing airlines within the other new EU countries that experienced the turnaround because of the "Open Sky" policy.

Reliability

As Saunders et al. (2003) explain, reliability is "the degree to which data collection method will yield consistent findings, similar observations would be made or conclusions reached by other researchers or there is transparency in how sense was made from the raw data" (p. 488). Qualitative analysis usually involves problems of reliability. However, we have tried to overcome errors and biases in several ways. First, although one of the thesis authors has constantly been exposed to stories about airBaltic from her family members, the other author could bring in a critical viewpoint from outside. Second, the presence of both authors during all interviews and the semi-structured type of the interviews allowed reducing interpretation problems of the responses. Although three interviews were conducted in Latvian, the translated information should not differ significantly since both of us are native Latvians.

Furthermore, all of the questions discussed during the interviews and responses have been documented in English and sent to the respondents for approval. Third, all of the respondents in airBaltic were different top-level managers which made the discussions more open since they have authority to decide how much information can be disclosed. Since some of the questions asked were the same for all respondents, we were able to verify that the collected information matched. Fourth, the interview with the government representative allowed us to reduce the bias of getting only the viewpoint of airBaltic itself. Consequently, we believe that another researcher would reach similar conclusions when conducting the same research with the same method.

3 Theoretical Background

This section lays a theoretical foundation of the research. It consists of five main chapters each discussing a specific theory or a theoretical concept. First, the theory of **Industrial Organization** is briefly examined, as it is the root of the **Five Forces of Competition Model** that follows in the second chapter. Both theoretical bases have been chosen with an aim to examine the external factors that can influence the strategy of a company. The third chapter deals with the **Resource-based View of Strategy** that focuses on the internal analysis of a company, since the company's internal resources and capabilities have a large impact on its **Competitive Advantage** that is discussed in the following chapter. The section ends with a brief overview of the **Knowledge-based View the Firm** which is considered as a natural extension of the Resource-based View of Strategy.

The main focus in the thesis is put on the Five Forces of Competition and the Resource-based View of Strategy. Our choice of theory was based on the collected data that showed which direction we should take in order to explain the development of airBaltic. We consider the market environment at the time of airBaltic development as historically unique, and Five Forces of Competition seemed to be the best tool of analyzing industry characteristics, since different influential factors are taken into account. The Resource-based View of Strategy, on the other hand, was chosen because it shows that not only industry characteristics determine strategy of a company, but also its internal resources and capabilities. This forms a justification of the heterogeneity of companies within the same industry. Thus, the choice of theory can be divided into two main perspectives: outside-in and inside-out perspectives.

3.1 Industrial Organization

Industrial Organization (IO) theory as a model to analyze a company's strategy was developed by Edward Mason and Joe Bain, with a focus on industry based explanations, such as concentration and entry barriers (Powel, 1996). The idea behind this theory is that a "firm's performance in the market-place depended critically on the characteristics of the industry environment in which it competed" (Porter, 1983, p. 176). IO follows the structure-conduct-performance model, where the structure is defined as environment that influences the rivalry among the buyers and the sellers (Caves, 1992). Conduct consists of the policies that a company adopts towards pricing, production, R&D, marketing and other variables

(Porter, 1983). This middle phase, conduct, serves as a link between industry structure and the quality of the performance. According to Caves (1992), market performance is “our normative appraisal of the social quality of the allocation of resources that results from a market’s conduct” (p. 15).

In 1980 Porter started to apply the concept developed by IO economists and identified several unanswered questions. He used this concept to derive “a bridge between industrial organization and strategic planning” (Porter, 1983, p. 177), later called Porter Five Forces model. The core of the model is that in any industry there are five competitive forces whose collective strengths are important in order to evaluate the industry attractiveness (Porter, 1983). Porter considers the industry environment as an area of intensive rivalry between buyers, suppliers and competitors driving industry competition. During our research the Porter Five Forces model will be used in order to find those external factors that have influenced the development of airBaltic since the theory continues to be helpful and the most widely used framework for analyzing the industry structure.

3.2 Five Forces of Competition Model

A company’s business environment is constantly influenced by external and internal factors that shape daily decisions and the company’s performance. According to Grant (2005), the heart of the business environment is created and influenced by customers, suppliers and competitors. In order to be profitable a company must make value for its customers. “Value is created when the price the customer is willing to pay for a product exceeds the costs incurred by the firm” (Grant, 2005, p. 69). Companies must also understand and create relationships with their suppliers. At the same time, understanding competitors is of crucial importance since intensity of competition could influence value-creating activities.

Porter’s model *Five Forces of Competition* is commonly used in order to specify and analyze different factors that could affect the company’s profitability and competitiveness. Therefore, first, the attractiveness of an industry, and, second, a company’s position within the industry are analyzed. As Porter (1991) explains, “that is what strategy is all about – making choices about how you position your company in its competitive environment; [...] no matter how attractive the game is, you will not do well if you do not hold a good position in it” (p. 90).

In any industry there are five competitive forces that collectively determine the attractiveness of the industry:

- Three sources of “horizontal” competition – threat of substitutes, rivalry among existing competitors and entry of new competitors,
- Two “vertical” sources of competition – bargaining power of buyers and bargaining power of suppliers (Grant, 2005) (*see Figure 1*).

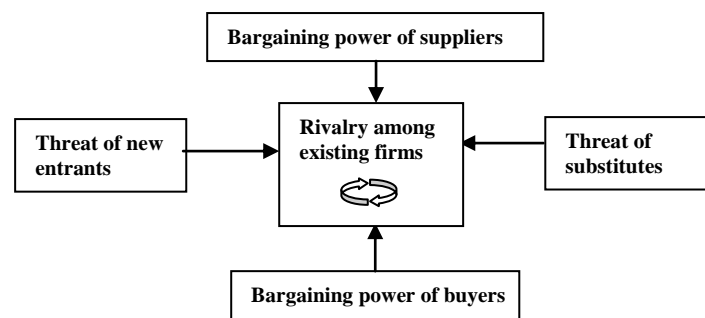


Figure 1. Five forces of competition.

As Porter (1985) further explains, each company strives to capture a profitable and sustainable position within an industry in order to defend itself from the influence of the forces that determine the industry competition. Although the structure of the industry is defined by exogenous factors, every company can influence each of the five forces through the competitive strategy in its own favour (Porter, 1983). However, the strength of each individual force can vary across industries and change over time as an industry grows, and not all of the forces are equally important for different industries (Porter, 1985).

Several authors have pointed out limitations of the model. According to Besanko et al. (2007), the Five Forces approach ignores both changes over time in consumer income and preferences, and changes in companies’ strategies in order to reinforce demand. A few authors have also criticized Five Forces model because it does not account for the role of a government. Besanko et al. (2007) mention that the government as a regulator could affect profitability of an industry, and therefore it should be introduced as the sixth force. Furthermore, from the perspective of the Five Forces approach, it is assumed that companies are free to access the required assets in order to compete in the industry and the chosen market position which may not always be the case (Teece, Pisano and Shuen, 1997).

Internal Rivalry

Competition among the existing companies within the industry is the major determinant of the overall industry profitability. “If someone is always attacking your position, that makes industry less attractive and less profitable” (Porter, 1991, p. 90). The competition could take either of the two forms: an aggressive strategy when the market participants use price pressure or a more gentle strategy when the market participants focus more on new product innovation and advertising. Basically, companies are jockeying for the market share in the industry (Besanko et al., 2007).

There are several factors that influence internal rivalry. Rivalry is commonly measured by a *seller concentration* ratio, where the market dominated by a few large firms is characterized as a highly concentrated market. As a consequence, competitors recognize their dominance and mutual interdependence that often leads to price similarity. In such situations competing firms usually focus on image and new product development (Grant, 2005). In general, internal rivalry intensifies when industry is characterized by high fixed costs, slow growth, excess capacity and lack of product differentiation (Ghemawat, 1999).

The second factor that determines the internal rivalry is the *industry*. In industries where the growth rate is relatively low, the companies must steal market shares from the competitors in order to expand, and that usually intensifies competition (Besanko et al., 2007). *Exit barriers* are costs incurred by a company in case of leaving a specific industry (Porter, 1985). These costs vary across different industries and generally, if there are high exit costs, companies will compete more aggressively and remain in the industry even when the business is not profitable (Ghemawat, 1999).

Different national origins, costs, strategies and management styles are other factors that could influence price competition. A combination of those factors is often called as *diversity of competitors* (Grant, 2005). Furthermore, when there is no or weak *product differentiation* among competitors and the costs for switching from one brand to another are low, there will be increased incentives for companies to cut the prices in order to increase their market shares (Besanko et al., 2007; Grant, 2005).

Threat of Entry

The profitability of an industry is influenced by existing and potential competitors. As a new entrant comes in the market, the existing product demand will have to be divided among more sellers which leads to a more intense rivalry (Porter, 1991). As Ghemawat (1999) explains, “the key concept in analyzing the threat of entry is entry barriers, which act to prevent an influx of firms into an industry whenever profits, adjusted for the cost of capital, rise above zero” (p. 28). There are different types of entry barriers and most of them require large *capital investments* in order to defend a company from competitors in the industry (Ghemawat, 1999). As a result, new entrants will not face the same market conditions as established companies in the industry (Grant, 2005).

According to Porter (1979), new entrants must invest a lot to establish a strong reputation and create *brand loyalty*. It may take a long time to build brand awareness, irrespectively of how much money and time the company invests in advertising. In some industries brand loyalty is the highest entry barrier.

Government actions can play a decisive role by affecting entry barriers through different laws that favour some companies over the others (Besanko et al., 2007). Grant (2005) mentions that barriers created by the government are the most efficient ones. Through different laws and norms the government could keep out potential competitors. Furthermore, new competitors without the *industry-specific knowledge* face higher costs than established companies within the market. Newcomers could face cost disadvantage as the accumulated experience of specific market gives lead to already established companies (Porter, 1997).

Substitutes

“Whatever your business does, customers nearly always have other ways of satisfying their needs” (Porter, 1991, p. 91). Ghemawat (1999) mentions that all products which perform a similar function should be seen as substitutes. Threat of substitutes depends on the price-to-performance satisfaction ratio of a product/service. If a substitute exists in the market, competition in the industry will be intensified (Besanko et al., 2007). The degree to which customers are willing to change one product for the other depends on the accessibility of information and involved costs. Nowadays the use of the Internet has facilitated the accessibility of information on available substitutes, thus increasing the information transparency (Grant, 2005).

Bargaining Power of Buyers

The bargaining power of buyers gives a customer ability to negotiate the price that could squeeze out a company's profit margins (Besanko et al., 2007). The bargaining power depends on several factors. As Ghemawat (1999) mentions, one of the most important determinants of the power of buyers is the *size and concentration* of buyers relative to suppliers. It is obvious that the power of the former is greater than the latter if there are a few buyers that purchase a large amount of products and basically act as a monopolist. However, there is also a need to distinguish between the power of buyers and their willingness to use this power (Ghemawat, 1999).

The *access to information* about the sellers' prices and costs gives additional bargaining power to buyers. It should be noticed, however, that customers are more price sensitive if the product that they purchase is standard and undifferentiated, expensive and cover a significant proportion of their disposable income (Porter, 1997). The bargaining power of buyers increases with the IT development, e.g., introduction of an internet-based reservation system gives buyers a possibility to compare and choose the cheapest product/service.

Bargaining Power of Suppliers

The number and size of suppliers are the factors that determine the bargaining power of suppliers. If there are many small suppliers within the industry, the firm has a possibility to choose among them. The preferred supplier will be the one with the lowest price and the best quality products. Hence, in this case the bargaining power of suppliers is relatively low (Ghemawat, 1999). In contrast, Porter (1997) admits that "powerful suppliers can squeeze profitability out of an industry" (p. 5).

After having examined the external factors that can influence competitiveness of a company, a closer look at a company's internal environment will be made.

3.3 Resource-Based View of Strategy

Grant (2005) specifies that strategy is regarded as reconciliation of a company's resources and capabilities (R&C) with the opportunities that are caused by changes in the external environment. The resource-based view (RBV) focuses on the interface between strategy and the internal environment of a company, and regards the company as a pool of R&C that are the main determinants of its strategy and performance (Grant, 2005; Mahoney, 2005; Amit

and Schoemaker, 1993). Barney (1991), however, talks about the RBV as an internal analysis of a company's strengths and weaknesses. Mahoney (2005) states that since resources are in fact potential services or activities, the latter make each company unique. This perspective is considered to be a more secure foundation of a long-term strategy when rapid changes in the external environment exist (Grant, 1991).

According to Grant (2005) superior profitability might be achieved by two means: locating a company in an attractive industry, and gaining a competitive advantage over competitors. Although the IO perspective helps to determine an attractive position within a particular industry, according to the RBV there are differences among companies in profits within the same industry. Furthermore, there are few industries which can be characterized by a low degree or no competition because of prevailing internationalization and deregulation trends. Therefore, the RBV focuses on the inter-firm differences by analyzing the internal content of a company (Regner, 1999). It is interesting to note that in practice the two perspectives (IO and RBV) overlap and complement each other, because industry attractiveness is a consequence of the ownership of resources (Grant, 2005; Amit and Schoemaker, 1993).

Barney (1991) explains that the RBV rests on two main assumptions when analyzing sources of competitive advantage. First, companies within the same industry are heterogeneous in terms of the strategic resources they control. Second, it is assumed that these resources may be immobile which leads to a long-lasting heterogeneity. In contrast with Barney (1991), Teece, Pisano and Shuen (1997) admit that this heterogeneity only prevail in the short-run. Thus, "marshalling a set of complementary and specialized R&C which are scarce, durable, not easily traded, and difficult to imitate, may enable the firm to earn economic rents" (Amit and Schoemaker, 1993, p. 37). Furthermore, economic rents are a result of asymmetry in initial resource endowments, imperfect substitutability, appropriation and a fit between R&C and strategic industry factors. Attempts to replicate a company's strategy mean replicating specific resource combinations that have arisen from unique history and circumstances, are often specific to either a particular company or industry at a given time, and therefore are considered to be very difficult to implement (Grant, 2005; Amit and Schoemaker, 1993; Regner, 1999; Barney, 1991).

3.3.1 Two Aspects of the Resource-based View: Classic and More Dynamic

According to Regner (1999), two branches of RBV have emerged in research: a classical and a more dynamic one. The former has its focus more on a company's existing resources, while the latter focuses on the development of the company's capabilities. The classical approach is relevant if the analysis of a company's strategy is made in a historical perspective. Thus, a particular industry and resource position is analyzed at a specific point in time. However, there is no static environment, and both industries and resources owned by companies change (Hamel and Heene, 1994). Therefore, the more dynamic view helps to get an insight of how R&C develop over time through gradual accumulation. This perspective is more useful for strategy practitioners who have to plan in advance "about what will be needed in order to surpass competitors in terms of new industry and resource positions" (Regner, 1999, p. 136). The main focus of this approach is on the learning process of a company which constantly tries to adapt to the changing environment.

3.3.2 Resources and Capabilities

Different definitions of resources exist in the available research. Wernerfelt (1984) defines resource as "anything which could be thought of as a strength or weakness of a given firm [...], and which is tied semipermanently to the firm" (p. 172). Furthermore, Barney (1991) talks about resources as "all assets, capabilities, organizational processes, firm attributes, information, knowledge, etc. controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness" (p. 101). Grant (2005) identifies three types of resources: tangible, intangible and human resources. A lack of explicit and compromised definition of resources makes strategy analysis more difficult and subject to speculation. However, a distinction between R&C is important. According to Grant (2005) "resources are the productive assets owned by the firm; capabilities are what the firm can do" (p. 138-139). Capabilities are a company's capacity to deploy resources in specific combinations in order to reach the desired outcome. These combinations are firm-specific tangible or intangible processes developed over time through complex interactions (Amit and Schoemaker, 1993). Such capabilities as highly reliable service and responsiveness to market trends are mentioned by Amit and Schoemaker (1993) as examples. One way of identifying a company's capabilities is to look at the principal functions of the company and to identify capabilities attributed to each function (Grant, 2005).

When analysis on the industry level is made, certain R&C are the main determinants of profitability for industry participants. These are regarded as Strategic Industry Factors (SIF) which are created by complex interactions among industry stakeholders, and are distributed asymmetrically among companies within the industry (Amit and Schoemaker, 1993).

3.3.3 Dynamic Capabilities

Teece, Pisano and Shuen (1997) are proponents of the “dynamic capabilities” approach which focuses on exploitation of a company’s existing capabilities in order to address the changing environment. Thus a process of the resource development, deployment and protection is focused upon. This approach differs from and complements the RBV in that it recognizes the importance of renewing R&C together with the changing environment. The same authors identify several factors that determine a company’s dynamic capabilities: processes (current organizational practices and learning), positions (current specific asset endowments), and paths (strategic alternatives available due to path dependency). “Hence organizational processes, shaped by the firm’s asset positions and molded by its evolutionary and co-evolutionary paths, explain the essence of the firm’s dynamic capabilities and its competitive advantage” (Teece, Pisano and Shuen, 1997, p. 518).

Eisenhardt and Martin (2000) argue that the value of dynamic capabilities lies in a company’s possibility to change and adapt its resource base by creating, integrating, recombining and releasing resources in order to sustain the competitive advantage. It is interesting to note that although dynamic capabilities are path-dependent and differ in details, they exhibit similarities among industry participants, what is called “the best practice”. This violates the assumption of the RBV about long-term heterogeneity among companies. Instead, the authors argue that the long-run competitive advantage lies in resource configurations and not dynamic capabilities themselves.

3.4 Competitive Advantage

Grant (2005) defines competitive advantage as follows: “When two or more firms compete within the same market, one firm possesses a competitive advantage over its rivals when it earns (or has the potential to earn) a persistently higher rate of profit” (p. 225). It is important to note that competitive advantage may not always be characterized by higher profitability because current profit may be forgone in favour of future investment.

According to Grant (2005) “establishing competitive advantage involves formulating and implementing a strategy that exploits the uniqueness of a firm’s portfolio of R&C” (p. 136). Amit and Schoemaker (1993), however, state that a company’s competitive advantage derives from strategic assets that are a bundle of “difficult to trade and imitate, scarce, appropriable and specialized R&C” (p. 36). Furthermore, Hamel and Heene (1994) use the term “core competences” as those capabilities that are fundamental to create a company’s competitive advantage. An important characteristic of a core competence is its contribution to ultimate customer value. As Hamel and Heene (1994) explain, “A core competence must continue to give competitive advantage as the demands of the environment, and hence what constitutes a competitive advantage, changes. Therefore, the skills which underlie the core products and services of the firm must be constantly changing and improving over time via learning.” (p. 142) A search for the R&C that constitute competitive advantage is rather ambiguous, because behind the resources that build a competitive advantage are often other resources.

Relationship between industry determined SIF, and company-level R&C, and strategic assets is shown in *Figure 2*.

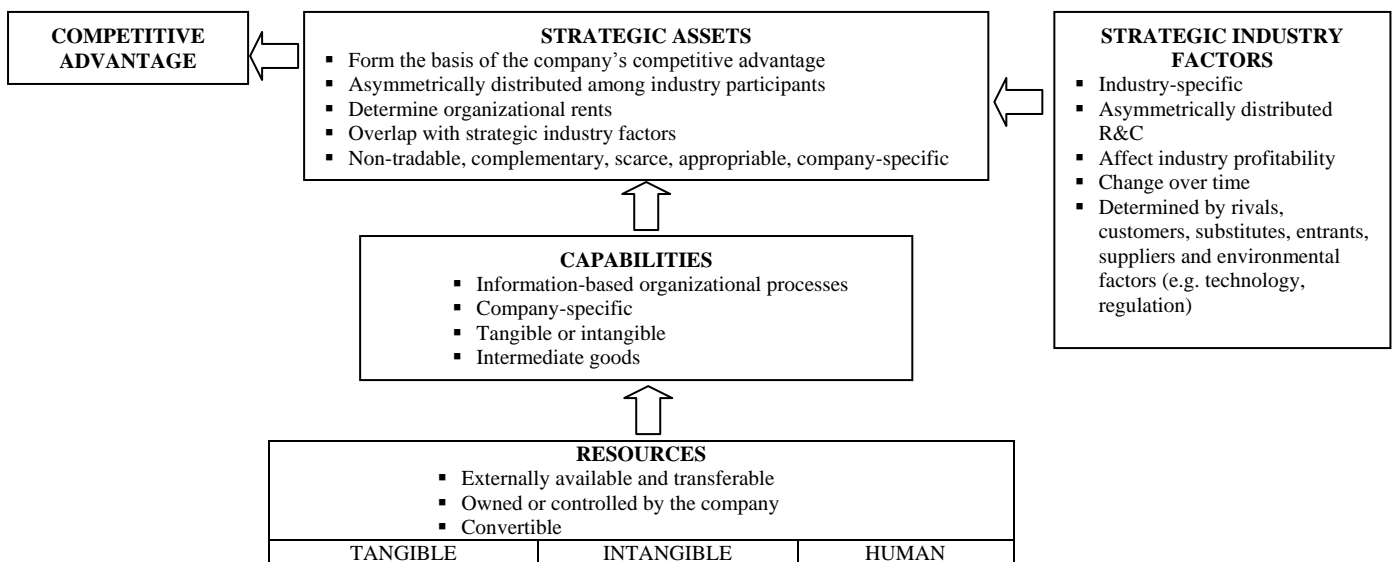


Figure 2. Relationship between resources, capabilities, strategic assets, strategic industry factors and competitive advantage (Grant, 2005; Amit and Schoemaker, 1993).

Since differences in profitability are considered as a disequilibrium phenomenon, competitive advantage arises when external or internal change occurs within the industry or the company, respectively (Grant, 2005). External change creates competitive advantage because of resource heterogeneity among companies and their differing ability to respond to the change. Grant (2005) admits that as customer requirements and nature of competition changes, companies have to adjust their capabilities and strategies. This requires one most important resource and capability: information and flexibility, respectively.

Competitive advantage cannot be easily imitated, since problems in linking superior performance to the R&C exist. This phenomenon is called causal ambiguity (Barney, 1991; Reed and DeFillippi, 1990). Causal ambiguity can be created if a company's capabilities are tacit and complex (Reed and DeFillippi, 1990). Tacitness refers to the accumulated skills through learning by doing. The more the competitive advantage is based on complex bundles of capabilities, the more difficult it becomes to track the company's success. Thus, causal ambiguity creates a barrier to competitive imitation which should be maintained in order to sustain the competitive advantage (Reed and DeFillippi, 1990).

Social complexity which cannot be systematically influenced by a company (e.g., reputation) is another phenomenon that makes the imitation of the strategy complex (Barney, 1991). Coyne (1986) assures that a capability gap between a company and its competitors should exist in order for a competitive advantage to be durable. Furthermore, Barney (1991) admits that a sustained competitive advantage exists if a company is implementing a value creating strategy the benefits of which are not and cannot be duplicated by any current or potential competitors.

3.4.1 First-mover Advantage

Ability of new entrants or competitors to imitate the success of an incumbent depends on the benefits that the first-mover advantage brings. This means that the initial player of the strategic position in the market gains access to R&C that are more difficult or impossible to access for the followers (Grant, 2005). When required resources are scarce, when initial competitive advantage creates profit that makes it possible for a company to invest and extend its resource base, when the first mover establishes a reputation within the market, and a cost advantage through learning can be created, first-mover advantage plays a major role.

Wernerfelt (1984) explains that in such situations the company enjoys the protection of a resource position barrier.

3.4.2 Types of Competitive Advantage: Cost and Differentiation

Grant (2005) specifies that there are two ways in which a company is able to achieve higher profit (or potential profit) than its rivals: either by supplying an identical product or service at a lower cost, or by differentiating it and charging a price premium. Cost advantage implies a company's willingness to become the cost leader in the market segment by offering standard and no-frills product. Differentiation, on the other hand, means providing a unique product or service that adds value to a customer beyond simply a low price. Different R&C and strategies are pursued by companies with either of the mentioned types of competitive advantage. Although Grant (2005) states that Porter (1980) views cost leadership and differentiation as mutually exclusive strategies, the former assumes that there is a middle way between the two strategies. As Grant (2005) explains, "in most industries, market leadership is held by a firm that maximizes customer appeal by reconciling effective differentiation with low cost" (p. 243). Even if differentiation is demanded for success, increased competition and deregulation (e.g. in airline industry) have made cost efficiency to become a prerequisite for profitability.

There are several factors called cost drivers that influence a company's unit costs: economies of scale, economies of learning, improved process technology, product design, the cost of inputs and capacity utilization, the importance of which differ between companies and industries (Grant, 2005).

When differentiation is pursued, an important prerequisite should be observed: reconciliation between customers' demand for differentiation and a company's ability to offer it (Grant, 2005). A thorough understanding of customers' needs and a company's abilities to adjust products or services more efficiently is thus crucial. According to Coyne (1986), competitive advantage of a company should be looked upon from the customer side and be translated into product attributes that form a key buying criterion. Differentiation is not tied to a particular function or activity, and can be created in virtually everything a company does. Compared to low cost, differentiation is a more secure basis for competitive advantage (Grant, 2005).

A different situation in terms of competitive advantage arises when mature industries, such as airline industry, are analyzed. As Grant (2005) states, “first, it (maturity) tends to reduce the number of opportunities for establishing competitive advantage; second, it shifts these opportunities from differentiation-based factors to cost-based factors” (p. 366). This fact results among others from increased buyer knowledge, product standardization, diffusion of the best practices in terms of process technology, developed industry infrastructure and low-cost overseas competitors, all of which make the position of an established company more vulnerable. Since cost efficiency in mature industries is rather a prerequisite for survival than a sustainable competitive advantage, such cost drivers as economies of scale, low-cost inputs and low overheads are considered to be particularly important (Grant, 2005). However, it is difficult to sustain cost leadership as a result of intensifying competition. Some degree of differentiation is necessary to break out from the fierce price competition, although the prevailing drop in prices has made customers less willing to pay a premium for differentiation.

3.5 Knowledge-based View of the Firm

Knowledge-based view of the firm can be regarded as an important extension to the RBV because knowledge is a particularly important resource and many types of knowledge are scarce, difficult to transfer and replicate. Furthermore, capabilities can be viewed as a company’s capacity to identify and apply the knowledge in order to create a basis for the company’s competitive advantage (Grant, 2005). Thus, a company is considered as a bundle of knowledge assets which are deployed in order to create value. A starting point of enhancing knowledge management within a company is to identify the linkage between knowledge and the ultimate customer value (Grant, 2005).

4 Case Description

The following case description is divided into three parts. It starts by introducing the reader with some **key facts about Latvia** that are relevant for the discussion of the strategy of airBaltic. Latvia is the home country of airBaltic and its focal market which makes it relevant to get an insight into the country's population, geographical location, economic growth and the overall development patterns. Since Latvia is not only the home-base of airBaltic, but also an attractive destination to business and tourism travellers, reasons for a traffic flow to and from the country are worth examining. Description of development and the current state of the **Latvian airline industry** follows in the second section, since it is important to know how the market has developed and what the competitive situation looks like. The last section introduces the **airline airBaltic**. The section gives an insight into the company's path of development and changing business practices in order for us and the reader to be able to identify the internal and external factors that were critical to the successful expansion of airBaltic.

4.1 Key Facts about Latvia

Latvia is one of the Baltic States which from a former Soviet Union country in 2004 became a member of the European Union (EU). It is bordered by Estonia, Lithuania, Belarus and Russia, and is the closest point in the EU to the East. The geographical proximity to the Scandinavian countries as well as the location between Europe and the Commonwealth of Independent States (CIS) makes Latvia geographically well-situated. The territory of Latvia covers 64,589 sq km, and the population of Latvia is 2,284,871. The capital of Latvia is Riga which is situated in the centre of the country. It is the biggest city in the Baltic States with 724 707 inhabitants in year 2006.¹

Recent reforms and integration in the EU have positively influenced the country's economic growth. Latvia has the highest economic growth rate among all EU members. Since 2001 GDP has increased by 8.1% on average. An even more rapid increase could be observed during the last two years when the GDP growth rate was over 10%. The high growth rates can be explained by the stable increase of domestic demand and export. That is ensured by increasing income, wide crediting possibilities and entry into EU. The real income of

¹ <https://www.cia.gov/library/publications/the-world-factbook/geos/lg.html> (Accessed 10.11.2007)

employees has increased by 33% during the period between 2000 and 2005. However, consumption expenditures are growing faster than disposable income. The historical consumption restrictions and isolation from the rest of the world outside the borders of the Soviet Union is a partial explanation to people's willingness to increase consumption and travelling.² As Doganis (2006) explains, the growth rate of air traffic closely follows the growth of gross domestic product with an income elasticity of around 2.

Since Latvia joined EU, the amount of Foreign Direct Investment (FDI) has grown. The major investors among the EU members are Sweden (17% from the total amount of FDI during the first six months of year 2006), Estonia (13.1%) and Germany (11.7%). Russian FDI constitutes 7.7%.³ Hence, the amount of foreign business transactions has grown considerably during the last years.

Much effort has been made recently into developing Riga as the biggest conference and exhibition centre in the Baltic region. Investments in infrastructure are constantly being made in order to support the development of Riga as a business and cultural centre. Latvia is rapidly developing as an attractive tourist destination because of sandy beaches along the coasts, newly-opened SPA resorts and a culturally-rich capital.

4.2 Latvian Airline Industry

The Airline industry has traditionally played an important role in the Baltic States, since there has not been a sufficiently active railway and ferry traffic even up to nowadays. Furthermore, there is a lack of a sufficient amount of modern highways.⁴ As a result, air traffic has become one of the main means of connecting the Baltic States with Europe, and the Latvian State is interested in encouraging competition in Riga airport.

“We can already observe the result of the EU “Open Sky” policy and increased competition in Riga airport – drop in prices. Competition enhances development of the market. Riga airport is currently the size of Tallinn and Vilnius airports together in terms of daily operated flights. Profit of the airport and operating airlines are not of vital importance in

² Report of Economic Development of Latvia

³ Report of Economic Development of Latvia

⁴ Sloga, 14.11.2007

this case. The state perceives aviation rather as an instrument than an end in itself." (Director of the Aviation Department of the Latvian Ministry of Transport Arnis Muižnieks)

Riga airport was built at the present location in October 1974. Today it is the major airport in the Baltic States in terms of operated flights and passenger turnover. During the first ten months of the year 2007 the passenger turnover in the Baltic airports was as follows:

- Riga – 2 664 556 (27.1% growth compared to the same period last year);
- Tallinn – 1 459 765 (11.5% growth);
- Vilnius – 1 448 994 (15.2% growth).⁵

In comparison, the total number of passengers at Arlanda airport (Sweden, Stockholm) in 2006 was 17 540 000 (2.6% growth compared to the previous year).⁶

Traffic flow in Vilnius airport grows slower than in Riga airport because of high airport and over-flight charges. Although Lithuania is the biggest among the three Baltic States, it has the smallest airport due to the country's airline policy.⁷ Furthermore, both from Lithuania and Estonia the traffic to the CIS is much smaller than from Riga as cultural and economical ties historically have been stronger between Riga and CIS.⁸

Until 1991 Riga airport was used mainly for flights to and from countries within the former Soviet Union. Only in 1991, when Latvia regained its independence, Riga as a destination appeared on the timetables of well-known Western airlines - first SAS, then Lufthansa. Latvian Airlines (Latavio), a newly established state-owned Latvian airline, had a stable position in the market during a period of 1991-1995 by offering scheduled passenger flights to 13 European and Russian destinations.⁹ Another player worth mentioning was Baltic International Airlines, although it only operated flights to a couple of European destinations. Because of sky-high ticket prices relative to the income level in Latvia at that time, airline service was used by a tiny part of Latvian inhabitants.¹⁰

"There were 2.2 million passengers flying to CIS in 1990 and around 0.3 million to a few western destinations. The retrieval of the independence of the Latvian State had an

⁵ <http://www.riga-airport.com/?id=4309> (Accessed 19.11.2007)

⁶ <http://www.lfv.se/upload/Flygplatser/Arlanda/PDF/FACTS.pdf> (Accessed 25.12.2007)

⁷ Krastiņa, 23.06.-29.06.2006

⁸ Interview with Bertolt Flick

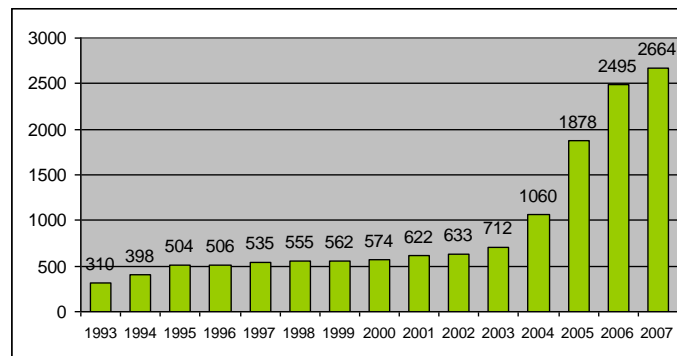
⁹ http://www.caa.lv/index_lv.php?m=7&c=LAVeesture (Accessed 20.11.2007)

¹⁰ <http://www.riga-airport.com/?id=328> (Accessed 22.08.2007)

enormously bad influence on the Latvian airline industry when the number of passengers from Riga airport dropped from 2.5 million to 300 000 in 1992. Only the last year did Riga airport reach the 2.5 million level of passengers, most of whom to Western destinations.” (CEO of airBaltic Bertolt Flick)

The number of passengers at Riga airport has grown year by year from 1993 to 2007. An especially rapid growth has been observed during the last 4-5 years (*see Figure 3*).¹¹ Among the EU countries Riga airport was the fastest growing airport in terms of number of passengers in 2006.¹² Moreover, it seems that this year will end with an additional record as Riga airport reached the level of 3 million passengers¹³.

Figure 3. Number of passengers in Riga airport during 1993-2007 (thousands).*



** The first 9 months of 2007*

The accession to the EU changed and broadened Latvia's economic area. The "Open Sky" policy enabled all EU airlines operate an unlimited number of flights.¹⁴ Low-cost airlines entered Latvia's airline industry and significantly changed the structure of flights, passengers and airport services. In 2006 there were 16 airlines that operated flights from Riga airport: airBaltic, Aer Lingus, Aeroflot, Austrian Airlines, British Airways, ČSA Czech Airlines, EasyJet, Finnair, KLM Royal Dutch Airlines, LOT Polish Airlines, Lufthansa, Norwegian Air Shuttle, Ryanair, SAS, Turkish Airlines un Uzbekistan Airways.¹⁵

¹¹ <http://www.riga-airport.com/?id=329> (Accessed 15.11.2007)

¹² Bidders, 14.12.2007

¹³ <http://www.riga-airport.com/?id=4309&lang=lv> (Accessed 15.12.2007)

¹⁴ <http://www.riga-airport.com/?id=328> (Accessed 22.08.2007)

¹⁵ Riga International Airport Annual Report 2006

From 1993 to 2006 the number of flights at Riga airport has grown from 11 704 to 40 162.¹⁶ The largest number of flights last year was operated by airBaltic, followed by Ryanair (*see Table 1 in Appendix for detailed information*). Consequently, airBaltic has carried the largest number of passengers (*see Table 2 in Appendix*). Today Riga airport is used as a hub by only 3.5% of all passengers, but it is expected that transfer traffic will become more important for Riga airport.

Riga airport has received funds from EU which are currently used for lengthening the airport runway. At the same time, several modernization and expansion projects are performed. It is anticipated that Riga airport will be able to serve 5-6 million passengers a year in the nearest future.¹⁷ In comparison, currently Arlanda airport has the capacity to serve 25 million passengers.¹⁸ Also the newly opened flight simulator at Riga airport for both pilots and cabin crew will increase attractiveness of Riga as a destination for education.¹⁹

4.3 airBaltic

4.3.1 Basic Company Information

Latvian airline "Air Baltic Corporation" Ltd. was founded in 1995 when a joint venture agreement was signed between the initial shareholders: Latvian State (51%), SAS (29%), Baltic International USA (8%), Swedfund International AB (6%) and IØ Danish Investment Fund for Central and Eastern Europe (*See Figure 1 in Appendix for an overview of the company's history*). Today the company's shareholders are the Latvian State (52.6%), SAS AB (47.2%) and Transaero (0.2%).²⁰

"The initial agreement between airBaltic and SAS provides that airBaltic should repay its loan from SAS until a specific period of time which has now been approached. If that is not done, SAS is able to take over shares from the Latvian State. As a result, there is a risk of airBaltic losing its flights from Riga to outside the EU because of the nationality rule²¹." (Director of the Aviation Department of the Latvian Ministry of Transport Arnis Muižnieks)

¹⁶ <http://www.riga-airport.com/?id=336> (Accessed 31.08.2007)

¹⁷ <http://www.riga-airport.com/?id=328> (Accessed 31.08.2007)

¹⁸ <http://www.skycontrol.net/ep-4/stockholm-arlanda-airport/> (Accessed 25.12.2007)

¹⁹ Vikmanis, 08.10.2007

²⁰ <http://www.airbaltic.com/public/26558.html> (Accessed 22.08.2007)

²¹ **Nationality rule** – a rule that requires governments to designate airlines to operate their country's traffic rights to the third countries (outside the EU) only if they are substantially owned and effectively controlled by

airBaltic was established at a time when the competition in the market was weakened. “The government-owned Latavio was about to stop its operations, and there was a strong wish from the Latvian side that the new airline should start operation immediately. As a part of the agreement, Baltic International Airlines stopped their operations and returned their traffic rights to the Latvian authorities”.²²

Initially, airBaltic was intended to be the preferred airline for business travellers to/from Riga. Supporting strategies included development of tourist and ethnic traffic to/from the Baltic States and developing Riga as a transfer hub for traffic flow from Scandinavian countries to Eastern and Central Europe as well as the former CIS. The company’s initial vision was to become the major airline in the Baltic region.²³ Currently the company employs approximately 950 people, the majority of whom are directly involved in flight operations. Since March 1, 2002, Mr. Bertolt Flick is the company's President and CEO.²⁴ airBaltic is focusing mainly on point-to-point²⁵ traffic, although transfer passengers currently constitute 10-15% of all airBaltic passengers. According to the CEO of the company,

“airBaltic does not strive to become a major carrier of transfer passengers, because Riga is not situated in such a beneficial position as to become a major hub between East and West. However, Riga has geographical advantages in the North”.

Currently (in November 2007) airBaltic is operating direct flights from two Baltic capitals: Riga, Latvia (37 routes) (see Figure 4) and Vilnius, Lithuania (18 routes); Liepāja, the third largest Latvian city (3 routes) and direct flights between Kaliningrad and Copenhagen. airBaltic is a flexible airline that makes seasonal changes in its route map in order to adjust to the customers’ seasonal preferences. The company’s fleet consists of 3 types of aircraft - ten 120-seats Boeing 737-500, three 149-seats Boeing 737-300 and eight 50-seats Fokker 50, in total - 21 aircraft.²⁶

nationals of their own country. Since January 1993 the European Union’s “Third Package” allows airlines within the EU to be owned by nationals or companies from any member state. However, ownership of an EU airline by non-EU nationals or companies is limited to 49 per cent. (Doganis, 2006, p. 20; 55)

²² airBaltic Annual Report 1995, p. 12.

²³ airBaltic Annual Report 1995.

²⁴ <http://www.airbaltic.com/public/26566.html> (Accessed 22.08.2007)

²⁵ **Point-to-point traffic** – carrying passengers from one destination to another by direct flights

²⁶ <http://www.airbaltic.com/public/26557.html> (Accessed 22.08.2007)



Figure 4. Direct flights operated by airBaltic from Riga.²⁷

During the first years of the company’s history, a slow development in both the number of passengers, flights and destinations could be observed. However, the last 3-4 years have shown a steady growth in all of the previously mentioned indicators (see Figures 5, 6 and 7).²⁸

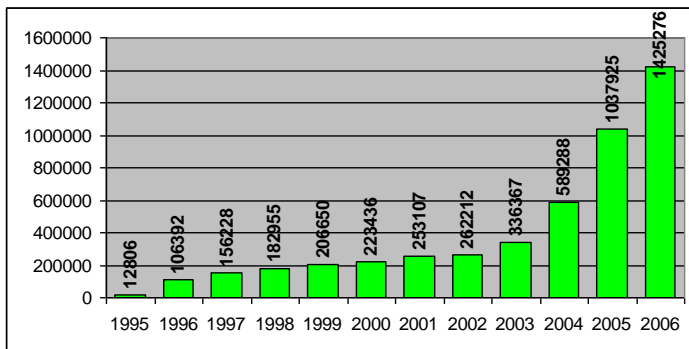


Figure 5. The number of airBaltic passengers 1995-2006.

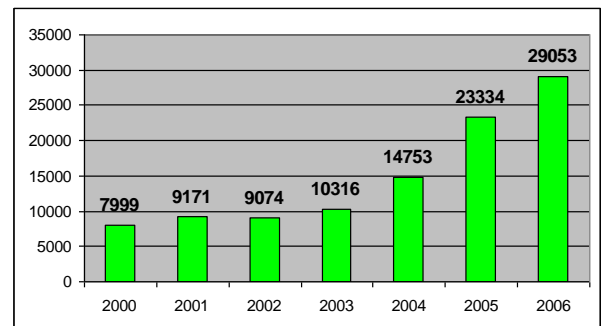


Figure 6. The number of flights operated by airBaltic 2000-2006.

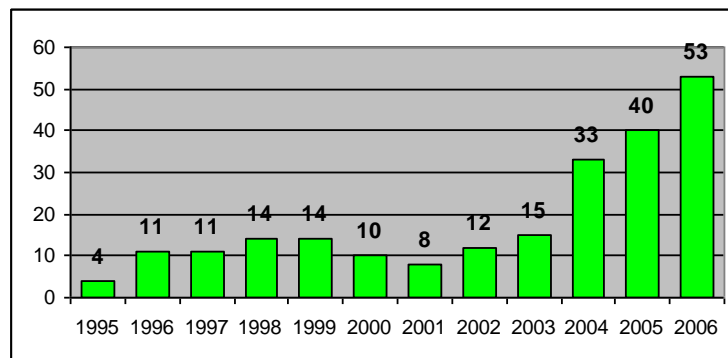


Figure 7. The number of airBaltic destinations 1995-2006.

²⁷ www.airbaltic.com (Accessed 20.11.2007)

²⁸ www.airbaltic.com (Accessed 20.11.2007)

airBaltic has shown steady improvements in key financial indicators during the last years (see Table 2). According to the CEO of airBaltic,

*“The successful results of the first nine months of the year suggest increasing demand in the market and will facilitate further development of the company, creating new jobs, increasing the fleet and expanding the route network”.*²⁹

Table 2. Key financial indicators of airBaltic.³⁰

	2005	2006	9 Months of 2007 ²
Passengers	1.04 m	1.42 m	+39%
Cabin factor ¹	56.6%	60.4%	+2.5%
Turnover MEUR	120.40	164.91	+40%
Operational result (EBITDAR) MEUR	13.80	22.89	+51%
Pre-tax profit (EBT) MEUR	-1.88	5.29	+51%
Net profit MEUR	- 1.62	6.13	
Routes	39	53	+7
Employees	626	790	948

1. The number of passengers carried to the total number of available seats

2. Results of the first nine months in 2007 compared to the first nine months in 2006

4.3.2 Partners

The strategic partner of airBaltic is SAS. It offers the widest choice of destinations within the SAS network for flights via Stockholm or Copenhagen. There is co-operation with SAS Group members – Spanair, Estonian Air, and Blue 1. airBaltic also has co-operation with Austrian Airlines and Turkish Airline Atlas Jet. Flights to the former Soviet Union are operated in code share agreements with Air One, Aeroflot, AeroSvit Airlines, Azerbaijan airline AZAL, Belavia, Donbassaero, Georgian airways and Rossiya Airlines.³¹

4.3.3 airBaltic as a Hybrid Carrier

From an airline primarily focusing on business travellers, airBaltic has become a hybrid carrier. Since the company is combining the practices of both traditional full service legacy carriers and low-cost carriers, it is considered to be a hybrid carrier. The former use both business and economy class, while the latter offer only economy class tickets. airBaltic is

²⁹ <http://www.airbaltic.com/public/31339.html> (Accessed 20.11.2007)

³⁰ <http://www.airbaltic.com/public/26566.html> (Accessed 02.09.2007);
<http://www.airbaltic.com/public/31339.html> (Accessed 02.09.2007);

<http://www.airbaltic.com/public/31852.html> (Accessed 20.11.2007)

³¹ <http://www.airbaltic.com/public/26566.html> (Accessed 22.08.2007)

adapting to some low-cost airline practices, such as providing passengers with an opportunity to buy meals on-board, one-way pricing, sales through the Internet and low ticket prices, while at the same time providing business class passengers with such services as priority check-in, flexibility, access to business lounges and meals on-board.

Worldwide airline industry trends have had an influence on the strategy of airBaltic. The most significant change of the market came with the accession of Latvia to the EU. Consequently, airBaltic is following the price pressure in the industry which intensified in 2004 when low-cost carriers entered the Latvian market. As the CEO of airBaltic explains,

*“airBaltic has been constantly decreasing the ticket prices since 2002. In Latvia, e.g., our average ticket prices adjusting for inflation have decreased by 50% during the last five years.”*³²

Most of the costs of airlines are similar, such as fuel, government charges (e.g. air space), wages, lease of aircraft, ground handling and others. According to the CFO of airBaltic Mārtiņš Antonovičs,

“The main way how airBaltic has been able to keep low unit costs is the regional advantages of lower labor and overhead costs, such as advertising which are, however, rapidly increasing.”

In addition, airBaltic tries to maintain high utilization of aircraft, flight deck and cabin crew. The high utilization of aircraft can be achieved by scheduling flights in such a way that departure times are adjusted to the preferences of passengers. For example, the priority for business passengers is frequent departures during the day, while transfer passengers value competitive price and elapse time, and therefore are willing to accept night departures.

However, since airBaltic introduced one-way ticket policy and low ticket prices, the company's total revenues have not decreased. As the CFO explains,

³² Oliņš, 27.11.2007

“It is only a perception of customers and “eye delusion” that ticket prices are low. Actually it is the fragmentation of the service that allows us to quote low prices. Although there is a trend of declining ticket prices, other sources of revenue will play a major role for airlines, such as insurance, car rental, hotels, SPA packages, mobile phone cards, sales of alcoholic beverages and others. The stream of revenues will get more fragmented and it will be able to cover revenues lost from ticket sales by other sources.”

The pricing policy of airBaltic is dependent on competition for specific routes. As the CCO of airBaltic Jan Lundborg explains,

“We directly compete with low-cost airlines for London and Dublin routes. At the same time for such routes as Moscow, Minsk, St. Petersburg and Stockholm we compete with traditional full service legacy carriers.”

4.3.4 Customer Segmentation

airBaltic segments its customers according to the purpose of travelling. According to the CEO, there are four main customer segments.

First, there is a customer segment that craves after sun and warmth. Because of the relatively short summers in Baltic States and Scandinavia people are dreaming about hot holidays. This is a big customer segment of airBaltic, and has high growth potential.

“Thanks to the larger variety of destinations and the lower prices airBaltic is able to offer, many Estonians and Lithuanians have started to fly from Riga. This has led to an extremely strong growth of passengers particularly from Riga, but also from our base in Vilnius.”
(CEO of airBaltic Bertolt Flick)

Second, there is a customer segment that chooses Riga as a weekend destination. These are people mainly from Scandinavia, Germany, Finland and Denmark. airBaltic is flying to such small Norwegian cities as Bergen, Stavanger and Aalesund, Swedish Gothenburg, and Finnish Oulu. Small Danish cities are included in the future plans of the company.

Third, airBaltic serves customers traveling between Riga and CIS. The growth of this group is significant especially from Riga. Compared to the traffic between Tallinn and Moscow

where only a minor growth can be observed (approximately 3% annually), the number of passengers flying to CIS from Riga is growing at 50-60% annually. Since Latvia was a member of the former Soviet Union, certain cultural and economic ties have remained with the current CIS members, and thus there is big demand for point-to-point traffic between Riga and CIS.

The fourth customer segment consists of business people traveling between Riga and such business centers as Stockholm, Copenhagen, Tallinn, Helsinki, Oslo Vilnius, St. Petersburg and Hamburg.

“There are three main criteria which our customers use in order to choose flights: time, price and elapse time. The importance of the criteria differs among the customer segments.”
(CCO Jan Lundborg)

airBaltic is a small and flexible airline that is able to constantly learn and adjust to the changing preferences of the four customer segments. There are several criteria which are used in order to evaluate new route possibilities. First, traffic flows between particular destinations are observed by looking at the competitors. Second, airBaltic tries to find out where there is a demand for charter flights. And finally, the company listens directly to the customers’ desires. airBaltic has close partnerships with local partners, such as tour operators which also influence the route choice.

In cooperation with Latvian tour operators, airBaltic has opened a number of holiday destinations in the Mediterranean. As the CEO states,

“Together we agreed on destinations and schedules, while Tez Tour (Latvian tour operator) takes a fixed number of seats on our flights. This reduces the financial risks for both, at the same time we are able to offer a wider choice of destinations to all our customers.”³³

³³ <http://www.airbaltic.com/public/31017.html> (Accessed 22.08.2007)

5 Analysis

This section is a synthesis of the empirical material presented in the Case Description and the theoretical background. Two main theoretical foundations, Porter's Five Forces and Resource-Based View of Strategy, are combined in the analysis in order to cover the most important factors behind the development of airBaltic. The former is used for the purpose of analyzing the external factors that influenced airBaltic, while the latter helps to look inside the company and examine which resources and capabilities had a major effect on the company's development.

The analysis of the company is divided into two stages:

- 1995 – 2003
- 2004 – today

Although the border of the phases might seem rather arbitrary and subjectively drawn, it has a solid foundation. Both phases differ in three characteristics: degree of competition, prevailing business practices and customer base. The first phase marked a gradual expansion of airBaltic in a relatively unsaturated market with a relatively low degree of competition. However, it should be noticed that the initial competitive situation did not remain constant during the whole phase. The level of competition was gradually increasing throughout the period. Since the focus of the strategy was business passengers, the whole business concept was primarily designed around the needs of business travellers. Furthermore, the high ticket prices relative to the income level in Latvia during that time made the service provided by airBaltic available to only a small fraction of Latvians. On the other hand, the "Open Sky" policy that came with the accession of Latvia in the EU in 2004 substantially changed the Latvian airline industry. During the second phase several new airlines entered the market and, hence, the prevailing business practices were changed. Following the industry price pressure, ticket prices of most of the airlines dropped, and leisure and ethnic travellers became the major focus of the strategy of airBaltic. Thus, simultaneously with the rapid economic growth in the Baltic States, the fraction of people who could afford the airline service grew substantially.

A metaphor related to the movement of an airplane is used for each of the phases. A similarity of airBaltic with an airplane budging from an aircraft stand and rolling on the runway can be seen during the first phase of the company's development. Therefore, a metaphor *Rolling* stage is used for the period of 1995-2003. The second stage is referred to as the *Take-off*

stage, because the gradually developed route network and accumulated experience in the market made airBaltic ready to take-off in the fiercely competitive sky.

The analysis consists of two sections. The first and the second section deal with analysis of the factors behind the successful development of airBaltic through a lens of the two theories during each of the previously mentioned phases.

5.1 The Rolling Stage

This chapter presents analysis of the Rolling stage: a period of 1995-2003. First, the Five Forces of Competition model will be used as a tool of analysis. Then, internal analysis of airBaltic will be made with a help of the Resource-based view of the strategy.

5.1.1 Five Forces of Competition

Internal Rivalry

During the first years of this early phase the competition in the market was weak, and, basically, airBaltic could act as a monopolist and set the market trends. As a country that had gained its independence only a few years ago, Latvia was new and still unknown for many tourists. Furthermore, the domestic demand was also still low, which made an interest of domestic and foreign investors to develop airline business in Riga fairly weak. Only a few well-known Western airlines gradually showed interest to enter the Latvian airline market, first SAS, followed by Lufthansa. Throughout the phase several airlines opened a few routes from Riga, resulting to a gradually increasing level of competition.

Another factor that influenced the competitive situation was the decision of stopping operations of the government owned Latavio. Before the establishment of airBaltic the company had a strong position in the market. If its operations had not been stopped, it would have been much harder for a new company to enter the market. Furthermore, the company that opened a way to airBaltic was Baltic International Airlines that stopped its operations and returned its traffic rights to the Latvian government. The general situation in Latvia can be characterized as follows: a new country without a well-functioning infrastructure and low domestic income, in combination with a strong desire of the government to establish a local airline, gave airBaltic an initial lead in the Latvian airline market.

Threat of New Entrants

When analyzing the development of airBaltic it seems obvious that the threat of new entrants should be crucial for the first decisive steps of airBaltic. As mentioned previously, the market

was relatively undeveloped and the interest of tourists about Latvia was fairly low. Consequently, that could be the reason why other major airlines decided to wait with the market entrance since the costs involved were higher than the revenues that could have been gained. It should not be forgotten that there were only 0.3 million passengers in Riga airport in 1992 compared to the 2.5 million at the end of 1990. This number shows that there had been a significant drop in demand, and consequently a decline in the market. The interest of other well-known European airlines to put Riga as a destination in their timetables was reduced as the Latvian state was behind its own airline, airBaltic. Thus, the state had a special interest in the development of airBaltic and could influence the norms and laws in order to minimize the outside competition. However, the relatively new and unsaturated market had much free room for more players.

Substitutes

Another decisive factor that influenced the development of airBaltic was the availability of substitutes, such as railway and ferry traffic. Furthermore, road system could be seen as a substitute for airline services as well. The transition from a planned economy to a market economy does not happen immediately. The first years of Latvia's independence were more like a search for the right way of leading the country. As a result, many aspects of infrastructure that was satisfactory before worsened. As an example, the once existing railway traffic between Riga and such popular cities as St. Petersburg and Moscow was reduced.

Ferry lines can be considered as another substitute for the airline service. In theory, the situation looks fairly nice since Latvia has three ice-free harbours, but the reality is rather different. Although, there is daily ferry traffic between Latvia and Sweden, there have not been ensured sufficiently good ferry connections with all the countries around the Baltic Sea. Furthermore, a question of ferry lines as a substitute for airline services is doubtful, since it takes much more time to travel by a ferry.

When looking at the size of all three Baltic countries, it becomes clear that the total territory covers 40% of the territory of Sweden.³⁴ After Latvia regained its independence in 1991, the interest of Baltic citizens to visit the closest neighbours increased. Since Latvia is situated in the middle of the Baltic States, it is connected to the neighbouring countries by highways. Therefore, highways can be considered as another substitute to the airline services. According to the theoretical foundations, if a substitute exists in the market which ensures a fairly similar

³⁴ <https://www.cia.gov/library/publications/the-world-factbook/index.html> (Accessed 20.11.2007)

outcome, the competition will intensify. However, a lack of sufficient amount of modern highways in the Baltic States opens up more opportunities of airBaltic to ensure good route connections within the Baltic States.

Bargaining Power of Buyers

Customer concentration ratio is the most important determinant of the power of buyers. During the Rolling stage it was mostly the business travellers who had a possibility to use airline services and pay the sky-high ticket prices. Since the business travellers constituted a small (around 20% of all passengers)³⁵ but a profitable customer segment, all of the business practices of airBaltic were focused on the needs of this particular segment. As the theory explains, when there are a few customers buying a large part of a company products the power of buyers is fairly high. In this case, it is not a question of the *number* of business travellers who were using the airline services, but the fact that the revenues collected from this segment covered nearly all of the company's expenses. Therefore, the business segment had a high bargaining power, because it was a major source of revenues for airBaltic. Consequently, this tiny, but profitable customer segment affected the decisions made by airBaltic, such as the choice of destinations, departure time and offered services.

Bargaining Power of Suppliers

Initially the growth of airBaltic was moderate. Therefore, it was extremely important for the company to identify those suppliers that could offer high-quality but relatively cheap products as the resources were limited. Overall all airlines face the same cost structure consisting of fuel, government charges, lease of aircraft etc. The greatest advantage of airBaltic was the relatively low overhead costs because of the regional advantages.

5.1.2 Resource-based View of Strategy

A closer look at the internal environment of airBaltic has to be made if one wants to understand how the company's strategy evolved in response to the external environment. Thus, several R&C that were critical for the development of airBaltic during the Rolling stage have been identified.

Critical Resources and Capabilities

In 1995 the Latvian airline industry was shaken when the government-owned Latvian Airlines (Latavio) was about to stop its operation. It was a question of international acknowledgment

³⁵ Interview with the CFO Mārtiņš Antonovičs

and pride for Latvia that recently regained its independence to have its own airline. As a result, airBaltic received initial support for winning the traffic rights and opening the first routes from the Latvian government. Governmental support can be regarded as an important and valuable resource for a newly-established airline in a country that had not yet gained recognition from abroad. Political and economic support from the government increased awareness of Riga as a destination in the Western world.

airBaltic was established as a strategic partner of Scandinavian Airlines (SAS) already from the beginning. This partnership was a resource that allowed airBaltic to take advantage of the knowledge and experience of a powerful and well-known airline. First, passengers were able to access any destination within the wide route network of SAS via the major European hubs where airBaltic flew. Second, the accumulated knowledge of the European airline industry of SAS was spilled over to airBaltic which was a new and inexperienced airline.

The partnership also guaranteed the participation of airBaltic in the SAS EuroBonus which is a service and loyalty programme for frequent travellers. A clear link between the resource (partnership) and the ultimate customer value can be observed. Since the majority of passengers and the target of the business strategy of airBaltic were frequent business travellers, it was of great value for these customers to participate in the loyalty programme. Although there were a few alternative airlines available for several Western European routes (e.g., Lufthansa), it was beneficial for customers to choose airBaltic because of its membership in the SAS loyalty programme. Furthermore, airBaltic gained from the already established worldwide reputation of SAS by being its strategic partner.

A very important resource that laid the foundation of a successful expansion of airBaltic was the initial management team which partly consisted of SAS managers. For a new and inexperienced airline, such as airBaltic was, it was highly valuable to adopt Western managerial practices. Thus, the know-how and experience of the Western managers allowed airBaltic to master the best business practices already from the beginning. The historical isolation of Latvia from the Western world had negatively influenced mindsets of Latvian managers, and therefore it would have been difficult for airBaltic to expand without the support of SAS managers.

First-mover Advantage

There are both costs and benefits of a first-mover advantage. When analyzing the development of airBaltic it becomes clear that the first-mover advantage played an important role, allowing airBaltic to push its way towards expansion. The benefits that the company gained from the first-mover advantage would have been more difficult or even impossible to access for the followers. So, what were those benefits?

The first and most important benefit was already discussed before – the governmental support. Since only one airline was intended to represent Latvia and gain the governmental support, airBaltic was in a privileged position which could not be easily imitated by potential local competitors. The airline could initially rely on the government's initiative for developing the route network and facilitating the process of going through the formalities. This saved much of the company's resources, such as time and information costs. The same benefit comes also from the experience of the initial management team of airBaltic that entered the company with already accumulated knowledge and experience.

By being the first local airline that offered several Western and Eastern routes from Riga, airBaltic established awareness and reputation in the market. Partly relying on the reputation of SAS, but also proving its own reliability, airBaltic became well-known in the Latvian market.

By constantly investing in the development of the company, airBaltic was able to expand its resource base. The route network, fleet and number of employees has constantly been enlarged since the company was established. It can be noticed that strengthening of the market position was easier during the Rolling stage than would have been during the Take-off stage because of relatively lower degree of competition. Thus, airBaltic took the market opportunity and expanded its route network at the right time. Furthermore, it was much less costly to learn from mistakes during the Rolling stage when airBaltic accumulated the market knowledge and tried to sense the market. Companies cannot afford to make mistakes anymore in the Take-off stage when such a fierce competition and sensitive customers exist. Consequently, it is much harder now for the current and potential competitors to catch up.

Chain of Effects

After having examined the most important R&C behind the successful development of airBaltic, a chain of effects has to be drawn in order to have a clearer understanding of how

those R&C overlapped with strategic industry factors and consequently created a competitive advantage for airBaltic (*see Figure 8*).

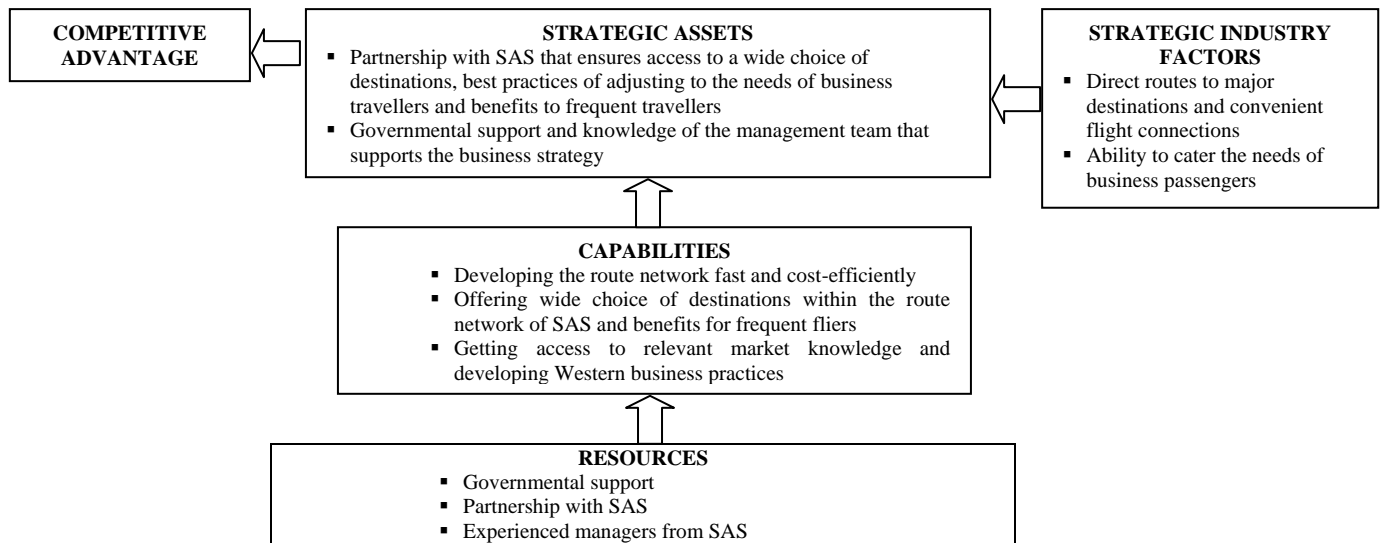


Figure 8. Relationship between resources, capabilities, strategic assets, strategic industry factors and competitive advantage of airBaltic.

The governmental support and the knowledge and experience of the initial management team are considered valuable resources that ensured that airBaltic had a capability of developing its route network fast and cost-efficiently. Simultaneously, the strategic partnership with SAS allowed airBaltic to stand for the same quality and service for business passengers as SAS did, and offer a wide choice of destinations and benefits for the business travellers. This capability of airBaltic was also its strategic asset, because it overlapped with the strategic industry factors – the main determinants of profitability for industry participants. Since business travellers were the main target group of airlines within the industry and the ones who mostly used the airline services, it was important to adjust to their needs both in terms of chosen routes and offered service.

Although airBaltic reported the first profit in its history in 2001, it can be said that the company had a competitive advantage in the market. The profit was forgone in favour of the future investments in the company's expansion. Already initially airBaltic offered several convenient destinations, while other competitors usually served only one or two destinations from Riga, such as Lufthansa. Furthermore, as mentioned before, it was beneficial for frequent travellers to choose airBaltic because of its participation in the SAS loyalty programme. Thus, it is obvious that airBaltic followed the differentiation strategy during the Rolling stage. Since business travellers were willing to pay for getting additional business-

class service and this service formed the key buying criterion, the practices of airBaltic were adjusted to the customers' needs. The priority of the company was not offering as low price as possible, but rather distinguish its service from other competitors by offering services that the customers were willing to pay for.

5.2 The Take-off Stage

The following chapter presents an analysis of the Take-off stage: a period from 2004 to present. First, again the external analysis will be made through a lens of the Five Forces of Competition model, followed by the internal analysis of airBaltic from the perspective the Resource-based view of the strategy.

5.2.1 Five Forces of Competition

Internal Rivalry

The Take-off stage came with substantial changes in the Latvian airline industry. Several simultaneous factors changed the rules of the game, and a new era began. The accession of Latvia to the EU in 2004 changed market conditions dramatically. From that time on airBaltic had to live with a constantly increasing level of competition. In 2006 it was sharing the market with 16 competitors which was a significant increase in competition compared to the previous stage. The "Open Sky" policy gave all EU members a right to operate unlimited number of flights; thereby internal rivalry intensified in the Latvian airline market. Number of flights in Riga airport increased drastically from 11 704 in 1993 to 40 162 in 2006, of which 19 144 were operated by airBaltic compared to the closest follower Ryanair with 4662 flights in 2006.

The general situation at this stage could be characterized as an increasing overall competitive pressure. The entrance of new traditional and low-cost competitors forced companies to compete more aggressively for the market share. The airline business involves high exit costs, and therefore some companies are practicing more aggressive strategies such as price pressure, while others are using more moderate strategies such as new product and service development. However, it should be noticed that in such a mature industry cost efficiency and consequently attractive pricing has rather become a prerequisite than a way to achieve a competitive advantage.

The entrance of low-cost airlines in the Latvian airline industry brought in unprecedented business practices. For airBaltic to retain its market position the critical factors are its

flexibility and ability to adapt to these new market practices, such as one-way pricing, sales through the Internet and low ticket prices. It can be concluded from the case study that airBaltic has both followed and introduced new market practices during its operation. The major change for the company was the shift from a “business airline” to a hybrid carrier.

Threat of New Entrants

Latvia with its sandy beaches along the coast, newly-opened SPA resorts and charming old town is an attractive destination for many tourists. In combination with the “Open Sky” policy more airlines from the EU could be interested to operate flights to Riga. Also an increasing traffic towards the East could provoke interest of Eastern airlines to start flights to Riga. This could have an influence on the profitability of airBaltic as the market would have to be divided among additional service providers. As a result market practices could also become more aggressive as brand loyalty is not always the highest entry barrier. Other factors, such as price and choice of destinations, are considered to be the most important buying criteria.

During our research we found out that, compared to the Rolling stage, today the Latvian government is more interested in encouraging competition in Riga airport than giving more advantageous conditions to airBaltic. On one hand, it is unfavourable for airBaltic since the entry barriers imposed by the government are considered to be the most efficient ones. On the other hand, the entrance of Ryanair in the market benefited airBaltic since it has gained from the volume discounts assigned by Riga airport to the biggest airlines. This, in combination with the market specific knowledge, has given a lead to airBaltic.

Substitutes

When analyzing substitutes during the Take-off stage we can conclude that they still do not comprise a real threat to airBaltic. The ferry between Riga and Stockholm still takes 17 hours while the ferry traffic between the Baltic Sea countries has been decreased. Another substitute that we identified in the previous stage is railway. During the last four years there have been some discussions about railway traffic between Tallinn and Berlin, but they have still stayed on the discussion level. Traffic connections between such popular destinations as Riga-Moscow and Riga-St. Petersburg have become worse as old trains have not been replaced and new ones have not been bought yet. We believe that the situation with Latvian highways will slowly become better as the Latvian government has received EU funds during the last 2-3 years, and there is a rapidly increasing amount of cars on the Latvian highways.

Bargaining Power of Buyers

There has been a rapid change in the economic situation of the Baltic States during the Take-off stage. Rapid economic growth, increasing incomes, wide crediting possibilities and enormous consumption patterns have increased people's willingness to travel, and thus demand for airline services. A special focus should be put on the bargaining power of customers when analyzing the development of airBaltic since powerful customers can squeeze out company's profit margin.

One of the reasons why the power of buyers has been increasing during this period is the development of IT. airBaltic is dealing with well-educated and cost-conscious customers who are not willing to pay for services that do not add to their ultimate customer value. Internet-based reservation systems give customers a possibility to compare the offers of all competitors and choose the one that gives the highest benefit/cost ratio. In this case, in order to meet all customers' needs, airBaltic segments its customers according to the purpose of travelling. This four group segmentation practice allows airBaltic to better understand the preferences of the specific group and adapt the service accordingly. As an example, business travellers require frequent departure times while travellers to holiday destinations demand a choice of attractive holiday destinations for low ticket prices.

Bargaining Power of Suppliers

Similar to the bargaining power of customers, strong bargaining power of suppliers can also squeeze out a company's profit margins. airBaltic as a service provider is highly dependent on all of its suppliers: providers of fuel, aircraft and others. It should be emphasized that the bargaining power of fuel providers is especially strong, since airBaltic is not able to influence the worldwide trends of oil prices. Consequently, airBaltic has been experiencing a big pressure during the Take-off stage when oil price has been constantly increasing. In order to be able to compete with the low-cost competitors, airBaltic has to find other ways of collecting revenues lost from the ticket sales, since it is not possible for the company to manipulate with the price of fuel, one of the largest cost items. While overall costs are similar for all airlines, airBaltic enjoys regional advantages of lower overheads. Furthermore, airBaltic has developed good relationships with tour operators. This allows the company to reduce the risk since an agreed number of seats are booked by the tour operators for particular flights. Tour operators also serve as a good information channel by helping airBaltic to identify customer preferences.

5.2.2 Resource-based View of Strategy

Several authors have argued that R&C that constitute a company's competitive advantage should be improved and adjusted to the changing market environment (Teece, Pisano and Shuen, 1997; Hamel and Heene, 1994). However, not all companies are able to respond to the changes because of the existing resource heterogeneity among the companies in the market (Grant, 2005). Consequently, it becomes obvious that those companies which are able to grab the moment of opportunity and use it in their own favour are the ones that have competitive advantage in the market. The latter is a story of airBaltic which explains its successful development during the last years. There are several reasons that explain the ability of airBaltic to respond to the changes in the nature of competition and customer requirements. Most of the explanations can be found within the company's R&C which will be discussed in the forthcoming paragraphs.

A Weapon against Competition – the Route Network

At the time when the competition in the market intensified, airBaltic had already developed a wide enough route network and thus gained a strong position in the market. At the end of year 2004 there were 33 destinations operated by airBaltic. The entrance of new competitors did not hurt airBaltic so much because the competitors could not immediately offer as many destinations from Riga as airBaltic. The first-mover advantage of airBaltic during the Rolling stage allowed the company to invest in expansion of its route network that served as a strong weapon during the Take-off stage. Since only a few routes of airBaltic overlapped with those of competitors, a sufficiently large passenger flow guaranteed a revenue stream that ensured the profitability of the company. Furthermore, the overlap of the routes did not necessarily mean that airBaltic passengers were lured to competitors, because a strong reputation of airBaltic, another very important intangible resource, ensured a stable basis of loyal customers.

When analyzing the factors that have positively influenced the development of airBaltic, one simple and obvious resource should not be forgotten – the geographical location of Latvia and especially Riga airport. All of the Western, Eastern, Northern and Southern European countries can be accessed from Riga within a few hours. The beneficial position of Riga, thus, has been playing a role in favour of airBaltic because the company has wide geographical opportunities to expand its route network. Although the “Open Sky” policy allows all European airlines to freely operate flights from any point within the borders of the EU, they are not allowed to fly outside the EU from Riga, if not at least 51% owned by Latvians. This

situation is highly beneficial to airBaltic which is able to expand routes towards all four cardinal points. Airlines from the EU can offer unlimited number of routes from Riga within the borders of the EU (which also take time to develop), and airlines from the CIS can operate direct flights between their home country and Riga; but no airline at the moment can have a multi-directional route network from Riga. As a result, it can be seen that airBaltic has a competitive advantage in the market by being able to offer accessibility of a wide choice of destinations within its multi-directional route network.

Following the Price Pressure

The wide route network would not serve as a strong weapon in competition for airBaltic if the ticket prices were so high as not to be able to attract customers. In other words, the possibility to get somewhere does not automatically guarantee that people can afford it or are willing to pay high prices. Therefore, it was essential for airlines to follow the industry price pressure and lower the ticket prices in order to ensure an increasing passenger flow. airBaltic did precisely this, and totally changed its pricing system. The high ticket prices targeted towards the business travellers were changed to lower affordable prices attractive to a wider customer base. However, it is not just a matter of changing the level of prices, but a question of the company's profitability. The explanation of the ability of airBaltic to successfully follow the price pressure lies in its relatively low unit cost which needs to be paid additional attention to.

Doganis (2006) argues that it is very important for airlines to reduce the unit cost, since lower costs allow them to be more flexible in pricing. Usually the largest cost item for airlines is labour cost. As Doganis (2006) explains, "labour (which for most airlines represent 25 to 35 per cent of total operating costs) is also a major cost differentiator between airlines competing in the same markets, since so many other input costs, such as fuel, landing fees, aircraft purchase and ground handling, will be broadly similar" (p. 24). Since its establishment, airBaltic has been enjoying the regional advantage of relatively lower labour costs compared to the competing airlines. During the Rolling stage this allowed the company to get higher margins and make investments into its further expansion. However, during the Take-off stage airBaltic was ready to meet the price pressure and fight against the low-cost competitors. As a result, the ticket prices of airBaltic are comparable to those of the low-cost airlines, such as Ryanair and EasyJet.

This is not an end of the story about the pricing system of airBaltic, because, if it was, no resources would be left for investments in the company's expansion. The company has found

another way how to respond to the fierce competition by not losing the business. airBaltic uses a route-specific pricing which means that higher but still attractive ticket prices are used for routes where there is a lower degree of competition or no overlap with the low-cost carriers. Where the price pressure is not so big, airBaltic is more flexible in setting the prices that the customers are willing to pay. At the same time, airBaltic has still kept business class on its flights which allows the business travellers to enjoy full service and the company to get a higher yield³⁶.

Service fragmentation is another method of getting more revenues from the service. airBaltic offers its customers such additional services as snacks and meals on-board, souvenirs, its own mobile phone card, travel packages, car rental and insurance. This method is a good way of differentiating the service while at the same time ensuring an attractive ticket price. Customers can enjoy low ticket prices, while they are free to choose whether they are willing to pay for the additional parts of the fragmented service. This, however, guarantees additional revenues for airBaltic that are lost from the ticket sales.

Learning by Doing – Dynamic Capabilities

In order to understand how airBaltic has been able to deal with the uncertain and changing environment, it is important to look at the learning process of the company which is the focus of the dynamic aspect of the RBV. The seasonally and yearly changing route network speaks for the fact that the company is constantly experimenting with the market and learning from its successes and failures. airBaltic is quick in finding what the customers' current preferences are and adapting to them. An example of that are the seasonal travel packages offered by the company. Such service as online check-in was introduced as the company discovered deficiencies in the Riga airport services.

During the years of operation, airBaltic has accumulated much know-how about characteristics and trends of different markets. The company has developed its own ways of sensing demand for new routes, and observed how the demand is being created. According to the dynamic capabilities approach, airBaltic has been constantly renewing its R&C in order to respond to the changing market environment. However, in line with the thoughts of Teece, Pisano and Shuen (1997), airBaltic has been able to develop new R&C to the extent that they conform to its existing R&C, the prevailing organizational processes and the path

³⁶ **Yield** is the average revenue collected per passenger-km. Passenger yield is calculated by dividing the total passenger revenue on a flight by the passenger-kms generated by that flight (Doganis, 2006, p. 296).

dependency. In other words, the company has been always renewing its R&C from the perspective of its current achievements and capacity to undertake new challenges. Changes in the pricing policy and the subsequent service fragmentation are examples of how airBaltic responded to the price pressure in the industry, and renewed its R&C in order to stay profitable.

An interesting point was made by Eisenhardt and Martin (2000) who argue that usually all industry participants follow “the best practice”, and thus dynamic capabilities of competitors are similar. This is true in the case of airBaltic. The low-cost competitors that entered the Latvian airline industry brought new business practices that were later also adapted by airBaltic. This shows that although competitors can follow the market trends and “the best practice”, each of them will do it differently because of the different R&C that they control. Therefore, the fact that all the airlines follow “the best practice” and adjust to the changes in the market does not mean that all of them will enjoy a competitive advantage. Other factors than just dynamic capabilities explain the competitive advantage of airBaltic.

Chain of Effects

After having examined the main R&C that have allowed airBaltic to respond to the turnaround of the market, a chain of effects will again be presented in order to see how those R&C overlapped with strategic industry factors and created a competitive advantage for airBaltic (*see Figure 9*).

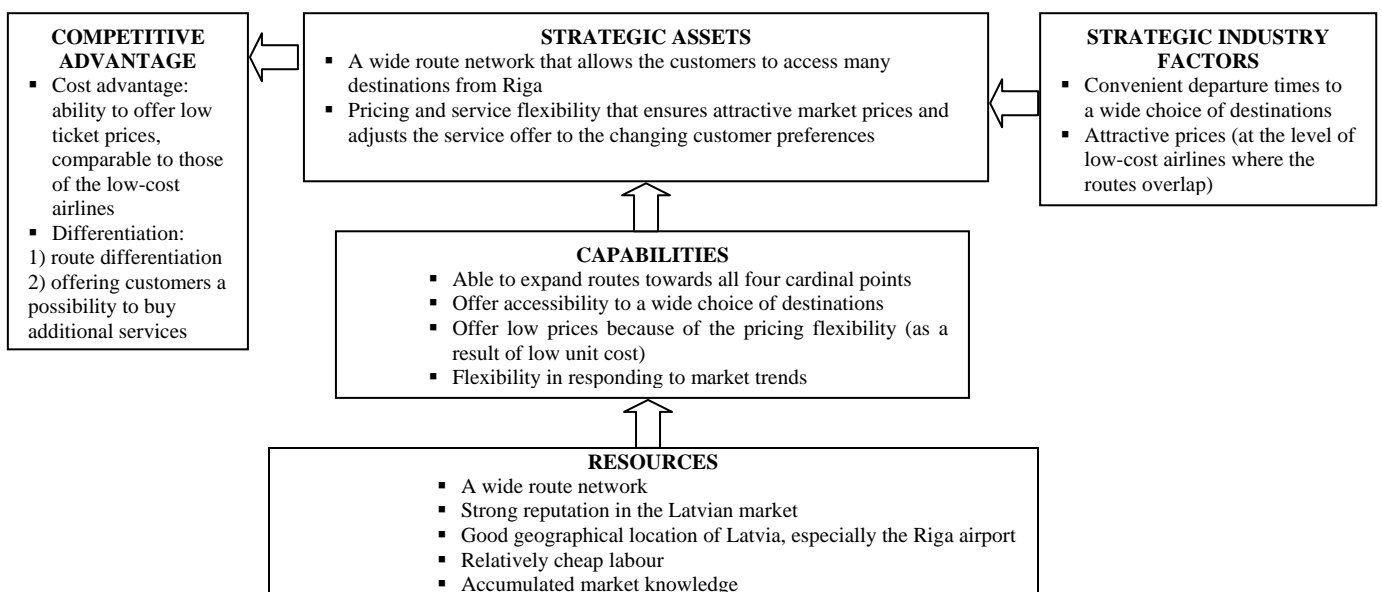


Figure 9. Relationship between resources, capabilities, strategic assets, strategic industry factors and competitive advantage of airBaltic.

The resources that were identified as critical to the successful expansion of airBaltic in the previous paragraphs have created several capabilities of airBaltic that subsequently determine its strategic assets. It is difficult to identify specific resources that were behind particular capabilities and strategic assets because all of the R&C work in combination. However, an effort has been made to track this chain to have at least a partial understanding of what contribution each of the R&C has.

The advantageous geographical location of the company's home base in Riga and its initial success in gradually developing the route network during the Rolling stage served as a strong basis of the further expansion efforts. The company has established a strong reputation in the Latvian market which makes services of airBaltic more attractive and demanded by the customers. Furthermore, following the industry price pressure, airBaltic lowered its ticket prices and made its flights accessible to a wider customer base. Behind this capability was the relatively cheap labour that allowed the company to ensure a low unit cost and be flexible in pricing. airBaltic is also flexible in responding to the changing customer preferences, since it has accumulated market knowledge of how to sense the changing customer needs and get up-to-date market information.

In order to determine what constitute the strategic assets of airBaltic, it is important to examine what the strategic industry factors are. Based on the analysis of the market, it has been concluded that an airline should offer convenient departure times to the demanded destinations for attractive prices in order to ensure its profitability. The previously mentioned R&C ensure that the strategic assets of airBaltic which create its competitive advantage are its wide route network and the pricing and service flexibility. Besides a wide choice of destinations, airBaltic is flexible in adjusting flight frequency and departure times according to the customers' needs.

It seems that airBaltic has found a middle way between both types of competitive advantage: cost and differentiation. airBaltic is operating in a mature industry where ensuring cost efficiency is rather a prerequisite than a way to achieve a competitive advantage. The market turnaround has made low ticket prices as one of the main buying criteria. As a result, airBaltic is not able to distinguish itself from the competitors with low ticket prices. Therefore, the company pursues also a differentiation strategy in order to gain a competitive advantage. One way how airBaltic differentiates itself from the competitors is by opening several routes which have not existed before and come as a surprise to customers. These are usually targeted

towards leisure and ethnic travellers who appreciate a possibility to have a direct flight to either a preferred holiday destination or a family residence. Furthermore, adding the frequency of flights to the “business destinations” is also a way of differentiating the service. Another type of differentiation is related to the additional services that airBaltic offers to its customers. The company can be not only a carrier, but also a supplier of a full travel package, including all the necessary components. Thus, airBaltic has constantly tried to reconcile the customers’ demand with its capabilities, and our analysis shows that the company has been successful so far. Taking into account the middle way that the company has chosen to follow in its strategy, it can be concluded that the competitive advantage of airBaltic lies in its ability to offer a wide choice of destinations targeted to different customer segments for a competitively low market prices.

6 Conclusion

The purpose of the thesis was to identify the critical external and internal factors that explain the successful development of airBaltic. The chosen theoretical framework allowed us to direct attention towards those industry and internal factors that could hide causes of success of airBaltic. However, our research looks at the development of airBaltic during twelve years, and definitely there have been a lot of factors that have played a role in influencing the company's strategy but could have been excluded from our analysis. In addition, all of the factors work in combination with each other, and it is difficult to identify the critical factors in isolation. Nevertheless, our ambition was to create a general picture of how the most important industry factors overlap with the company's internal resources and capabilities in shaping the strategy of airBaltic which laid the foundation of the company's success. This section is a brief summary of the critical factors identified in the analysis.

The main characteristics that differ between the Rolling and Take-off stages are the degree of competition, existing business practices and customer base. The market circumstances that prevailed during the Rolling stage can be characterized as beneficial for airBaltic. Through a lens of the Five Forces of Competition model it was identified that there were several critical industry factors that facilitated the development of airBaltic. The Latvian airline market was relatively empty, since two airlines with strong market position stopped their operations at the time when airBaltic was established. There was little interest from domestic and foreign investors to develop airline business in Riga because of low domestic demand for airline services and lack of attractiveness of Riga as a destination. There were no real substitutes of airline services in the market which gave airBaltic an opportunity to develop good connections with European and other countries. Furthermore, by focusing all of the business practices on the needs of business passengers, airBaltic served a profitable customer segment that used the airline service frequently. On the cost side, airBaltic enjoyed regional advantages of lower overheads which allowed the company to decrease the unit cost. If one most important factor has to be identified, it is the *weak market competition* prevailing at that stage that allowed the company to develop in a harmless market environment.

When looking at the internal environment of airBaltic, it becomes clear that several critical resources facilitated the successful development of the company. The governmental support and knowledge and experience of the initial management team were the resources that allowed airBaltic to expand its route network fast and cost-efficiently. Furthermore, the government was more interested in supporting its own national airline than developing the

market as such during the Rolling stage. The strategic partnership with SAS ensured that airBaltic was able to meet the demand of business travellers in terms of offered routes and service. Thus, there was reconciliation between the key buying criterion of business passengers and the service of airBaltic. We conclude that both *the governmental support and the strategic partnership with SAS* were the most important resources that formed the basis of the company's competitive advantage in the market.

Additional attention should be paid to the *first-mover advantage* that airBaltic enjoyed during the Rolling stage. By being the first national airline, airBaltic drained out the support from the government and established a strong reputation in the market which could not be later imitated by competitors. Using the favourable market conditions, airBaltic constantly invested in the expansion of the route network and strengthened its market position. Thus, it is obvious that airBaltic benefited from being the first national airline in the Latvian airline industry.

The Take-off stage came with major changes in the Latvian airline business. The "Open Sky" policy brought many new competitors in the Latvian market, including low-cost carriers that resulted in a substantial price pressure and changing business practices. The critical factor for airBaltic at this stage was its *flexibility* and *ability* to adapt to these new changes and also introduce new market practices. During the Take-off stage, the customer power has been increasing due to global IT development. The introduction of the four group segmentation practice has allowed airBaltic to better understand the preferences of the specific group and adapt the service accordingly. Service fragmentation has played a major role in the ability of the company to survive the increasing market competition and the increasing bargaining power of customers.

The first-mover advantage of airBaltic during the Rolling stage allowed the company to invest in expansion of its route network which served as a strong weapon during the Take-off stage. airBaltic was already strong enough to live with the ever increasing number of competing flights departing from Riga airport. Furthermore, airBaltic enjoys the advantage of being able to have a multi-directional route network from Riga due to the beneficial geographical location of Latvia and especially Riga airport. A very important factor is the company's ability to follow the industry price pressure due to its low unit cost, influenced to a large extent by relatively low labour costs. As a result, the company is flexible in pricing. The accumulated market knowledge of customers' needs has allowed airBaltic to respond to the changing customer preferences and be flexible regarding its service offering. In this case, we

conclude that *the already developed route network* was the main resource of airBaltic during the Take-off stage because without it the company could not be able to both follow the industry price pressure and rapidly expand its route network in order to catch up the obtrusive competitors. As a result, the competitive advantage of airBaltic lies in its ability to offer a wide choice of destinations targeted to different customer segments for a competitively low market prices.

During the process of writing the thesis we encountered a few moments when the theory we were using was not able to explain some circumstances. Our analysis showed that the governmental support was one of the most important factors during the start-up phase of airBaltic. Thus, we would agree with the criticism of the Five Forces of Competition model that pointed out a necessity to include the influence of government as the sixth force. In addition, we lacked some theoretical foundation of how and why the perception of the government changed during the analyzed stages. If initially it was interested in supporting its own national airline, currently it is interested in increasing competition in Riga airport. Thus, we lacked a link between the changing industry factors and the consequent changes in perception of the government.

Another issue that we sometimes got confused about was the fact that it was difficult to analyze the company during a period of twelve years. Although we divided the analysis into two stages, it was not possible to cover the dynamics of the company's development, resulting more in analysis of airBaltic at two points in time – 1995 and 2007. Although we tried to reflect the dynamic of the market changes, we have to agree to the proponents of the classic Resource-based view that the theory better helps to analyze a company in a historical one-point perspective.

Although there is a lot of criticism around state-owned airlines and the losses they bear, the case study of airBaltic shows that governmental support during the initial years of the company's establishment was one of the critical factors that allowed the company to develop fast and cost-efficiently. However, the partly ownership of airBaltic by SAS was the strategic choice that distinguished airBaltic from those state-owned companies that despite huge losses exist only because of the governmental support. The Western practices brought in the company during its development allowed airBaltic to learn from the experience of large, well-know airlines and not try all the mistakes on its own skin. This should serve as a learning lesson that Latvian companies still have much to learn from their Western counterparts. Most

of the local Latvian companies have a short-sighted view and focus on getting annual profit instead of thinking about expansion. The case of airBaltic shows that constant investments in expansion of the route network later were the main weapon that allowed the company to compete with the aggressive airlines that came in the market. Thinking only about today could lead to a situation when it is too late to catch up and build artillery to compete.

7 Further Research

This thesis had an ambition to find reconciliation between outside-in and inside-out perspectives: Five Forces of Competition and Resource-based View of Strategy, respectively. We have briefly touched upon the Knowledge-based View of the Firm, since it seemed as a natural extension of our theoretical foundation. However, there is much room for applying this theory more extensively when analyzing the strategy of the company. Furthermore, it would be interesting to see what analysis of the company's financials, operations, management style and structure could say about the critical success factors of airBaltic.

As we already mentioned, we lacked some theoretical foundation of how and why the perception of the government changed during the years about the support given to airBaltic. Perhaps, a deeper analysis of the role of the government in airline industry could give a better insight in this issue. Outside-in analysis of an airline including the sixth force in the Five Forces of Competition model could explain this governmental issue that our chosen theories overlooked.

The analysis in this thesis was intended to cover all of the period of the operation of airBaltic. However, as we found out, it was hard to cover the dynamics of the development, and our analysis was based more on two points in time: establishment of the company and nowadays. Therefore, it would be interesting to see analysis of the company for each successive year of the company's development and compare how the results differ from our findings. That would also allow seeing the small turning points that influenced the strategy of airBaltic.

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9 Appendix

Table 1. Aircraft movements per airline in Riga airport.

Airline	2004	2005	2005/2004 (%)	2006	2006/2005 (%)
Aer Lingus		54		375	594%
Aeroflot	410	438	7%	448	2%
Air Baltic	14 002	16 056	15%	19 144	19%
Austrian Airlines	560	738	32%	733	-1%
British Airways	539	701	30%	732	4%
ČSA	1 054	1 518	44%	1 249	-18%
Easy Jet Airlines	72	642		562	-12%
Finnair/Aero	1 655	1 231	-26%	1 238	1%
Hemus Air		10		30	200%
ISRAIR	30	34	13%	4	-88%
KLM	847	1 445		1 448	0%
Latcharter	721	792		855	8%
LOT	604	874	45%	970	11%
Lufthansa	1 296	1 306	1%	730	-44%
Norwegian Air Shuttle		42		482	1048%
RAFAVID	114	84	-26%	50	-40%
Ryanair	346	3 078		4 662	51%
SAS				86	
Turkish Airlines				202	
Uzbekistan Airways	72	390	442%	320	-18%
VIP Aviation	581	413		290	-30%
Air Polonia/Sky Express	548	902	65%	1 063	18%
Apatas	483	128	-73%		-100%
Euronean Air Transport	506	512	1%	522	2%
Others	2 885	3 164	10%	3 967	25%
Total	27 325	34 552	26%	40 162	16%

Source: Riga International Airport Annual Report 2006

Table 2. Passenger movements per airline in Riga airport.

Airline	2004	2005	2005/2004 (%)	2006	2006/2005 (%)
Aer Lingus		6 711		55 015	720%
Aeroflot	25 955	29 556	14%	28 695	-3%
Air Baltic	530 900	769 107	45%	1 002 205	30%
Aurela	990				
Austrian Airlines	15 829	25 238	59%	30 104	19%
British Airways	61 765	77 164	25%	82 034	6%
CSA	67 339	87 844	30%	91 963	5%
Easy Jet Airlines	6 683	76 099	1039%	71 676	-6%
Finnair/Aero	60 330	47 728	-21%	55 996	17%
Hemus Air		792		2 923	269%
ISRAIR	4 869	5 182	6%	499	-90%
KLM	50 749	87 104	72%	100 049	15%
Latcharter	81 631	97 584	20%	119 299	22%
Lithuanian Airlines		3 191			
LOT	18 131	24 178	33%	26 639	10%
Lufthansa	74 250	67 862	-9%	57 122	-16%
Norwegian Air Shuttle		5 047		49 294	877%
RAFAVIO	1 532	622	-59%	51	-92%
Ryanair	44 907	427 246	851%	664 976	56%
SAS				3 522	
Turkish Airlines				9 732	
Uzbekistan Airways	3 400	28 803	747%	27 044	-6%
Others	726	662	-9%	424	-36%
Total	1 060 426	1 878 035	77%	2 495 020	33%

Source: Riga International Airport Annual Report 2006

Figure 1. Historical overview of airBaltic.

August 1995 – Latvian airline "Air Baltic Corporation" Ltd. (airBaltic) founded as a joint venture between the initial shareholders: Latvian State (51%), SAS (29%), Baltic International USA (8%), Swedfund International AB (6%) and IØ Danish Investment Fund for Central and Eastern Europe.

October 1995 – The first flights start with the company's first airplane – Saab 340.

1996 – airBaltic acquires its first AVRO RJ70.
airBaltic joins SAS EuroBonus Program.

1997 – airBaltic opens Cargo Department.

November 1998 – The first airBaltic Fokker 50 arrives in Riga.

1999 – All airBaltic Saab 340 airplanes are replaced by Fokker 50.
airBaltic registers change of its legal status – from limited liability to joint-stock company.

2000 – Establishment of the "Baltic Cargo Center" which is a modern cargo-handling terminal built and operated in Riga airport by the joint venture between airBaltic, SAS and Globe Ground.
airBaltic receives a status "Well Connected with SAS".

2001 – airBaltic carries the 1 millionth passenger.
SAS purchases the shares owned by Swedfund International AB and IØ Danish Investment Fund for Central and Eastern Europe. The new shareholder structure: Latvian State (52.6%), SAS AB (47.2%) and Transaero (0.2%).
airBaltic reports profit after taxes of USD 88 thousand (56 000 LVL) for the first time in the company's history.

2002 - The fourth airBaltic aircraft Fokker 50 is delivered to Riga.
airBaltic closes 2002 with 406 Thousand LVL (EUR 675 000) profit after taxes.

2003 – airBaltic got the first Boeing 737-500 airplane.
airBaltic implements a new pricing structure – one way ticket concept. The price of tickets directly depends on demand.
Ticket sales from the company's website are launched.
The fifth airBaltic aircraft Fokker 50 is delivered to Riga.
airBaltic closes 2003 with 1,1 Million LVL (EUR 1.63 million) profit after taxes.

June 2004 – airBaltic is the first airline in the Baltic States which took the advantage of "Open Sky" following EU accession and started operations from Vilnius airport.
5 more Boeing 737 and the sixth Fokker 50 join airBaltic fleet.
airBaltic introduces new corporate livery.
airBaltic overall net result for 2004 amounted to EUR 1,2 million (LVL 850 000) loss.

2005 – For the first time in its history, the company has carried over a million passengers a year.
airBaltic again enlarges its fleet which now consists of 16 aircraft: 7 Boeing 737 and 9 Fokker 50.
airBaltic opens representative office in Berlin.

September 2006 – The millionth passenger of the year carried by airBaltic.
airBaltic adds another Boeing 737 to its fleet.
airBaltic closes the year with 4.305 m LVL net profit.

2007 – airBaltic opens a representative office in St.Peterburg, Russia.
The fleet is enlarged to 21 aircraft: 13 Boeing 737 and 8 Fokker 50.
airBaltic commences regular operations out of Liepāja.
airBalticcard Mobile, a pre-paid phone card, introduced.
airBaltic launches online check-in system.
airBaltic opens Vilnius-Chisinau route, the first in a series of East-bound routes from Lithuania.