

## NECESSITY OF RESTRUCTURING UKRAINIAN AIRLINES BUSINESS AND IMPROVING THEIR VALUE MANAGEMENT IN CONDITIONS OF EUROPEAN INTEGRATION AND INCREASED COMPETITION

**Abstract.** The article describes the qualitative and quantitative changes reflecting dynamics of the airlines development in the domestic and foreign air passenger transport markets. The reasons that caused bankruptcy of “Dniproavia” joint stock company are characterized; the results of regression models are assessed. The factors that dictate the need for restructuring Ukrainian airlines business on the basis of the international airlines experience are determined.

**Key words:** restructuring, market value, market capitalization, value management, competition, airline, air passenger transport market.

**Problem.** Modern processes of integrated global aviation business development show a significant effect that organizational structures, functional, technological and socio-political changes have on the increase of airlines capitalization and their economic security. Inclusion into the scientific analysis of social, moral, and political factors that affect the aviation industry economy as a whole and individual business entities, in particular, is a feature of the institutional approach to the of the airlines development prospects assessment.

At the beginning of the 21st century in conditions of deepening recession in Ukraine it is important to establish public-private partnerships, search for new target markets and choose innovative solutions of strategic nature that will determine the content of restructuring in the real economy and the airlines capitalization dynamics [1–3].

**Analysis of recent publications.** In today's business world all economic resources have become mobile, losing their national characteristics and geographic peculiarities of target markets. The corporate globalization has become a real world power as the monopolization of investment resources is about 90 %. Economic competition intensifies the global development conflict. The growing capitalization of industrialized countries in general and airlines, in particular, become relevant issues.

High-tech sectors of the world economy are demonstrating high rates of growth in the value of intangible assets, showing practical interest in the possibilities of using concepts of marketing and logistics in international management. Every year these sectors are increasing capitalization rates, the cost of national airlines brands is growing, revenues from leasing of aircraft and other facilities necessary for the passenger flows servicing are going up.

Global airlines are the driving force of structural and functional changes in national economies. The structure of their real assets reflects the effect of organizational innovations. In addition, ROI dependence on the volume of material resources involved in the sphere of air services is decreasing. During the world crisis famous brand airlines are gradually reducing transaction costs in the process of conquering new international markets (economies of scale). All of these phenomena eventually lead to changes of:

- aviation market competitive environment and critical resources coverage;
- redistribution of market power through M & A transactions;
- increase the investment attractiveness of effective airlines.

Thus, after the stock market collapse in 2008 the market capitalization of the world largest companies has grown by more than \$10 trillion. From 2008 to August 2013 only 67 companies preserved their positions in the ranking of the best 100 companies. In August 2013 the market capitalization of 100 world largest companies was \$13.6 trillion; the difference between the first and the 20<sup>th</sup> positions in the rating was \$215 billion. [4]. The phenomena of globalization in the business world reflect the high rate of change in the activities scale of large companies that carry out extensive maneuvers to create new barriers to market access. They are active in introducing into

practice the new rules on the market and an aggressive marketing policy. From 2008 to 2013 33 large companies were squeezed out from the list of TOP-100 not having the necessary resources for maintaining competitive positions. In recent years, due to strengthening influence of the financial and political capital market positions of major world leaders of aviation market are rapidly changing. More tough become political and trade restrictions by the EU against Russian international airlines in conditions of military conflict aggravation between Ukraine and Russia.

Global airlines are actively expanding its presence in the markets of the EU and Ukraine. In particular, the airline *Emirates*, based in Dubai International airport, on January 16, 2014 performed its first flight from Dubai to Kyiv [5]. According to experts, the direction of passenger flights Ukraine – United Arab Emirates (UAE) is dynamically growing and is expected to be one of the most competitive international destinations. Today direct flights between the two countries, in addition to *Emirates*, are performed by 5 more airlines – 3 Ukrainian and 2 from the Middle East. According to analysts, when *Emirates* enters this market sector the frequency of flights between the “Boryspil” and Dubai International will grow by 30 %. This will have a positive impact on the cash flows dynamics of the airline and the airports that are serving it. It should be noted that by 2020 the company plans to double its fleet. Since the beginning of its operation *Emirates* received over 500 international awards for its high level of service. Therefore, savings on transaction costs due to its famous brand is an important competitive advantage of the company. With the presence of such a large airline in the Ukrainian market the competitive environment is going to change. For small airlines that are engaged mainly in charter flights ordered by tour operators, the prospects of further survival in tough competitive environment are poor [6, 7]. Low-costers carrying tourists from tour operators are significant competitors to charter airlines. According to the government aviation agency, services of Ukrainian airlines in January-June 2014 were used by 1.8 mln. people, and charter flights were used by 815.8 thousand people, which is 21.1 % less than the same indicator for the previous period (charter services in June 2014 were received by 229.8 thousand people.). Because of the lack of demand in 2014 charter flights were

partially canceled. At the beginning of 2013 Ukrainian air company “Aerosvit” stopped its operation.

Management of domestic airlines should focus their particular attention on shaping the image of their companies and gaining customer loyalty, on creating high value services to clients. The rating compiled by Business Insider, presents 20 worst airlines of the world. Ukrainian International Airlines (UIA) is placed the third from the end in this rating [8]. The main players in the market of charter airlines are two companies “Ukraine International Airlines” and Windrose. “Kharkiv Airlines” provides less volume of similar services. None of the Ukrainian airlines can match the level of capitalization of any foreign company, even that of AirAsia (7.6 bln.) [9].

Management of Ukrainian airlines should look for responses to existing challenge in strengthening the core competencies of all the employees; this will allow them to competently conduct business restructuring. Generalization of the above problem tasks suggests that scientific research focused on identifying opportunities of increasing airlines capitalization on the basis of restructuring their business is of special interest.

**The purpose of the research** is to summarize foreign and domestic experience of airlines operation and define peculiarities of factor interaction in the process of restructuring their business; to estimate possibilities of improving value-oriented management system of Ukrainian airlines in an unstable market environment.

**The main results of the research.** For more than twenty years the Ukrainian market of air passenger traffic, unfortunately, remains a monopoly and is closed to using modern marketing tools and innovative management technologies; this results in the air services price increase (for both passenger and cargo air transportation).

Introduction of modern paradigm of value-based management into the practice of managing airlines in conditions of their target markets instability (concerning cargo and / or passenger traffic) requires the simulation of different types of relationships at different levels – production and operational, organizational, marketing, intellectual and financial – to identify potential growth and cost increase.

In practice of enterprise management and assessment of restructuring in the system of value-

oriented management [9-12] the added value, in particular, the added value for shareholders, is the most commonly used indicator, which includes the following indicators:

- Market Value Added,
- Economic Value Added,
- Shareholders Value Added,
- Total Shareholders Return

However, due to different interpretations of the term, we consider appropriate to note the following criticisms of the category of “added value”:

Traditionally, the added value is treated as a multidimensional category covering functional and emotional benefits, estimated through consumers (clients) compared to competitors, but this category can also measure performance of the airline itself and of the real possibilities of its innovation and investment potential. Critical remarks on understanding and application of the concept of “value added” in the practice of airlines management are the following:

- Value added is the result of the airline success (e.g., efficient strategy application in the competitive aviation market within the national economy and international business);

- This category should be seen as a way to ensure the functioning of the airline as a single unit based on the integrated management system;

- Value added is part of intangible assets and / or internal processes that control cost, so a larger set of services is to provide the adequate benefit to the company;

- Value Added and added value should serve as the key categories of the management strategic thinking;

- the rate of the value added growth should be compared with the rate of income growth, this being an important condition for strengthening the airline economic security and its market position;

- to evaluate the performance of the majority of enterprises they use concepts, analysis methods and techniques based on financial indicators (Cash Flow, EVA, WACC etc.), but the category of “added value” should be treated multidimensionally, in particular, through non-financial indicators (Balanced Scorecard methodology (BSC));

- the scope of airlines value added formation is broad and covers a range of customers – both internal and external (creating value for customers – the external value, and creating value for the company – internal value);

- on the basis of enriching knowledge in the airlines strategic management it is expedient to point out innovative products, intellectual resources and value added in intellectual products;

- systematic measurement of the company value added permits to make an informed choice of airline development directions;

- enriching the meaning of the concept “airlines value creation chain” allows to understand the the added value formation mechanism both within individual airlines and aviation industry as a whole.

At the present stage of the aviation market development political constraints for international airlines that affect their ability to generate cash flows become severe. Thus, the total loss of capitalization of the major European and US airlines in August 2014 due to cancelling many charter flights in response to sanctions against “Dobrolet” Russian low-cost carrier (100 % subsidiary of “Aeroflot”), amounted to about \$4.5 bln. [13].

Modern conditions of domestic aircompanies operation have become stricter, changing their marketing vectors geography due to annexation of the Crimea and military events in Donbas. Fundamentals of industrial capital reproduction of both domestic and foreign air carriers are broken, conditions of credit resources attraction are worsening that negatively affects the process of generating net cash flows. Statistics of foreign companies shows that the dynamics of value added indicator (EVA) doesn't not determine sales increase, but spread – the difference between ROI and the weighted average cost WACC.

The urgency of this problem can be shown by the example of the high performance dynamics of PAT “Dniproavia” (Table 1). This company was practically not ready to work in tough competitive environment and to the power redistribution on the aviation market. There has been a sharp reduction of scale – income from sales of services reduced from 408 mln. in 2008 to 174 mln. in 2013. This led to significant losses, gross loss in 2013 was 134.336 mln. Operating activities were extremely inefficient: in 2013 unprofitable sales reached 76.8 %; and net loss amounted to 378.729 million.

These continuous losses suffered by PAT “Dniproavia” during 2008–2013 are the consequence of the absence of the systems integrated management of different types of the company activities as well as strategic thinking of management. In fact, a quite significant share in the operating expenses was taken

by other operating costs (costs of research and development, financial losses due to assets depreciation, changes in exchange rates etc.): in 2012 they were 70% and the share of labor costs was only 18.6 % of total operating expenses. We believe that the effective intellectual work should be sufficiently motivated, otherwise the airline will not have a stable foundation for innovative development.

**Table 1**  
**Performance dynamics of PAT “Dniproavia” in 2008–2013**

Years	Income	Gross profit	Cost of sales	Other operating costs	Net income (loss)
2008	408135	-119165	16433	88493	-216464
2009	734516	-198670	27393	43822	-274723
2010	1198357	-181837	70025	59043	-263289
2011	1068020	-267557	74936	54793	-373820
2012	333836	-134839	28863	233939	-424417
2013	174882	-134336	17636	118126	-378729

Source: compiled by the authors according to [14]

The rate of growing of the value added in PAT “Dniproavia” was significantly lower than the rate of growing of the total costs. This had a negative impact on the results of operating activities and, accordingly, on the investment attractiveness of the airline. At low listing of its shares on the stock markets it was

impossible to profitably issue securities and attract external funding for the purpose of introducing modern business technologies, improving quality of services and entering international markets. Figure 1 shows a trend that reflects Dniproavia public company income dynamics in 2008–2013. The passengers flows decreased after 2008 because of the deepening financial crisis and that undermined the economic stability of the company to external threats, particularly to unfavorable market conditions (Fig. 2).

In conditions of high hryvnia devaluation airlines operating costs spent on servicing passengers flows grow exponentially, leading to deterioration of their financial results. Small or low-cost airlines can not introduce advanced technology and provide high quality services due to lack of the working capital and falling demand for such services.

As can be seen in Fig. 2, even decrease of the number of unprofitable operations at PAT “Dniproavia” in 2013 could not offset the accumulated net loss and reduce the gap between the gross loss from sales of services and the net loss from all company activities – operational, financial and investment (net cash flows from operating and financing activities in 2013 were negative and amounted UAH76.165 mln. and UAH300.552 mln. loss, respectively).

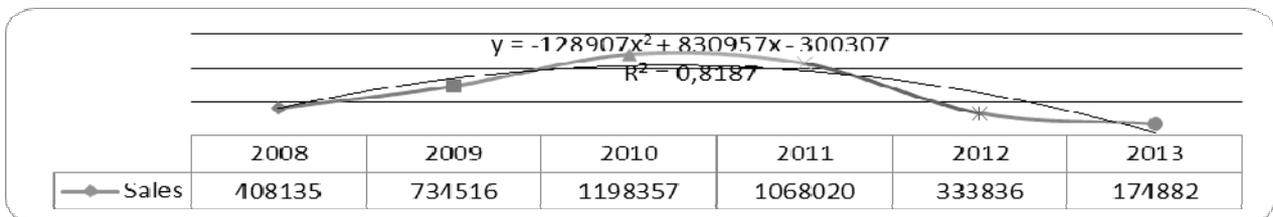


Fig. 1. The trend reflecting PAT “Dniproavia” income dynamics in 2008–2013 (in thousand UAH)

Note: constructed by the authors on the data from [14]

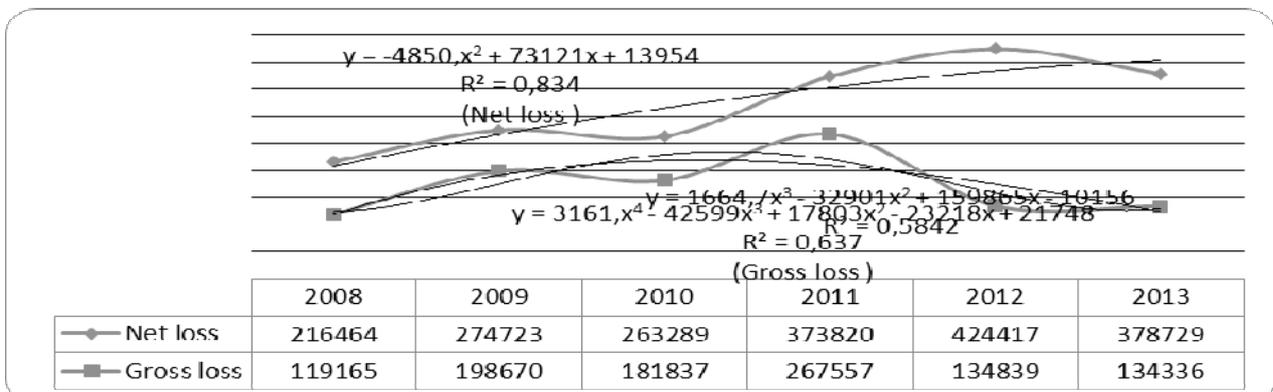


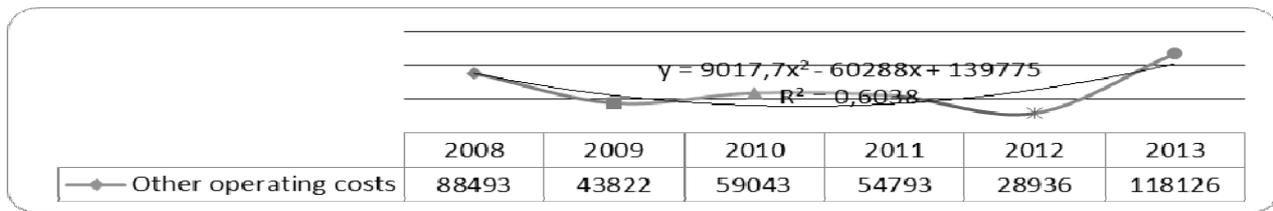
Fig. 2. Trends of gross and net losses of PAT “Dniproavia” (in thousand UAH)

Note: constructed by the authors on the data from [14]

The main long-term plans of PAT “Aviation Company” Dniproavia “, according to managers, cover the following areas: development of new internal and international air transportation directions; increase of passenger traffic; optimization of the aircraft fleet; business development in therelated fields. However, implementation of each of these development directions, in our opinion, requires high concentration of intellectual resources of the company to develop the competent business model and identify key parameters of business restructuring.

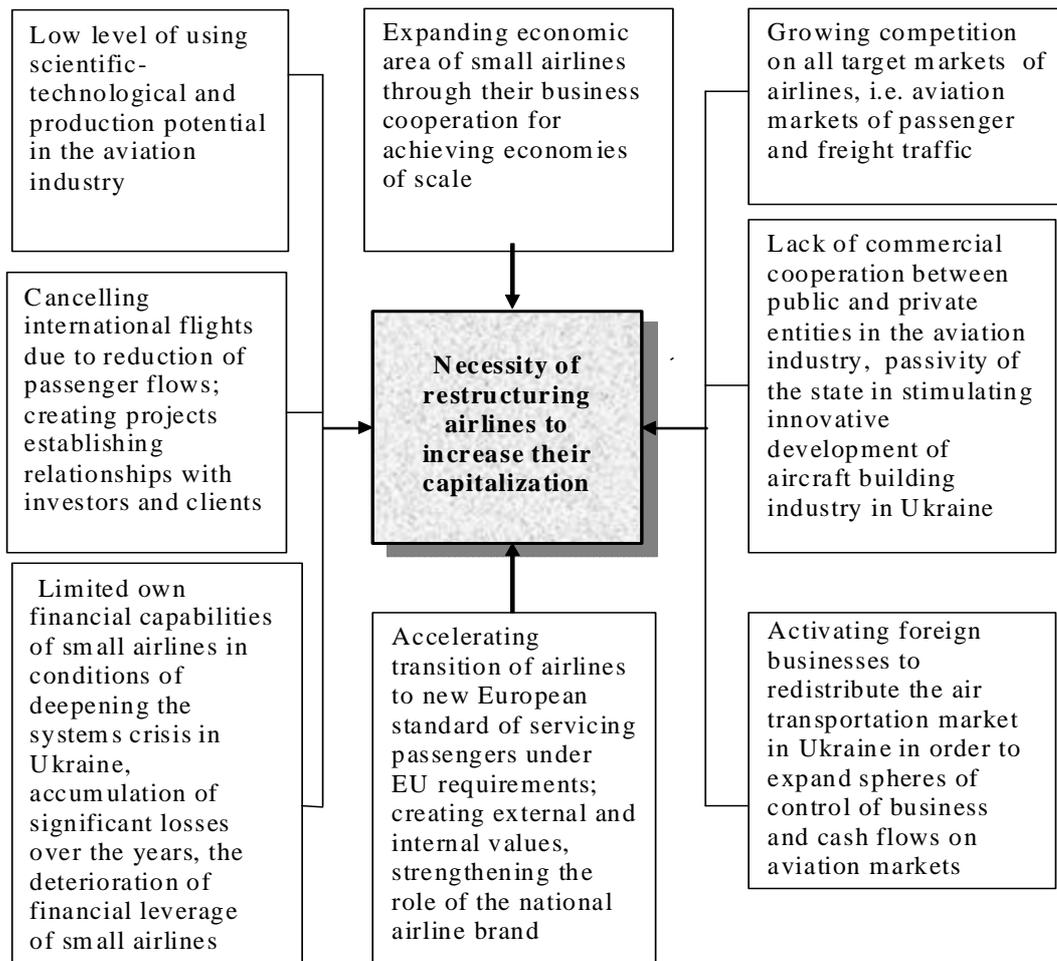
Proper cost management is impossible without revealing problems in operating activities and identifying the optimal combinations of services in the sectors of “low cost” and “full service”. Their solution mproves the financial results of the airline, in particular, due to reducing operating costs (Fig. 3).

In Fig. 4 the authors identify factors that determine the need to restructure the airline business and implement innovative approaches to the practice of passenger service.



*Fig. 3. Dynamics of other operating costs taken into account to assess the financial results of PAT “Dniproavia” operating activities (in thousands UAH)*

*Note: constructed by the authors on the data from [14]*



*Fig. 4. Factors determining the need to restructure the Ukrainian airlines business and to implement innovative approaches to the practice of passenger servicing*

The increasing dynamics of losses of Ukrainian airlines is affected, in particular, by an increase in airport charges. Thus, during 2007–2012 sales of services at the airport “Borispol” (services dealing with taking-off and landing of aircraft, ensuring aviation safety, providing extra parking time for aircraft, passenger service at the airport etc.) increased by 16 %. In Ukraine airfare increased by 30 % over night (February 5 – February 6, 2015) due to changes in the dollar exchange rate in the system of mutual settlements according to the requirements of International Air Transport Association IATA [15].

To reduce the negative impact of the devaluation of hryvnia on the cost of factors of production and finished products the management practice should implement business cooperation and the so-called model of joint actions. As noted by Porter [16], this approach requires the specific organizational context encouraging cooperation between subsidiary airlines.

Tough competition and debt burden significantly limit possibilities of airlines development and their access to credit resources (mainly due to the low value of liquid assets). So, another way to solve the problem of funding is to issue securities and their activation in the stock markets. For example, in 2009-2011 14 airlines IPO were announced totaling \$7.4 billion, 6 placements reached \$1.9 billion, three of them being in Asia. Until 2030, according to experts, the cost of new aircraft in Europe will be about \$800 billions (\$4060 billion in the world).

The growth of debt liabilities requires a comprehensive analysis of the processes of value creation and consumption by airlines. Hence, an indicator  $EV / EBITDAR$  (enterprise value / earnings before interest, tax, depreciation, amortization, rent), i.e. the ratio of enterprise value (market value plus accounts receivable minus cash) to its income before taxes, interest, depreciation and operating leasing is important in the system of value-based management. Operational leasing costs account for significant share of Ukrainian airlines expenditures as they rent expensive foreign airliners. After the bankruptcy of “Aerosvit” there also failed “Dniproavia” and “Donbassaero” airline. Experts prove the role of political capital in artificial bankruptcy and redistribution of airlines resources [17].

Specialized investment companies that serve the needs of airlines, particularly during their

mergers, are actively working in the world. Yet in 2010 American air companies United Airlines and Continental Airlines have agreed to unite by exchanging shares for 3.7 billion dollars. The effects of transactions like M&A of different airlines should be considered in quantitative and qualitative terms – through changing capitalization of the new company, its brand value as well as through changes in external values (for customers) and internal values (for own company) that it creates. Note that the portal Airline Ratings has prepared a list of the safest airlines for 2015 based on inspection carried out by the Federal Administration and the International Civil Aviation Organization. Safety is assessed for each airline by seven criteria. Australia's largest airline Qantas was ranked first. The rest top-rated safest airlines are: Air New Zealand – New Zealand's national airline, British Airways – one of Europe's largest British carrier, Cathay Pacific – Hong Kong's flagship airline, Emirates – one of the world's largest airlines in Dubai and others. [18,19].

**Conclusions.** In today's competitive business environment domestic airlines, especially low-budget ones, should seek competent business restructuring and formation of the core competence as their main strategic goal. This course allows airlines to get a synergistic effect and to get rid of their non-performing assets. Airlines management should develop strategic thinking towards elaborating strategies of interaction with customers and investors and setting up public-private partnerships. The problems concerning airlines costs and values should be investigated in a complex system of relationships “society–state–airline as the subject and the object of economic power” and the effectiveness of approaches to their solution should be evaluated in quantitative and qualitative terms. Without necessary timely structural and functional changes and improvement of the business model itself it is impossible to create conditions for formation of value, especially in the current circumstances of losing the aviation market target segments through the annexation of the Crimea, military events in Donbass, force majeure conditions and other events of global nature that are related to the need to harmonize Ukrainian legislation with EU requirements regarding the quality of passenger air services.

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