

The spoken word shall prevail.



**Speech by the President and Chief Executive Officer
of Swiss International Air Lines Ltd.**

Dr. Christoph Franz

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Good afternoon Ladies and Gentlemen,

It is a great honour to have been invited to address the International Aviation Club and I would like to thank you for your kind invitation.

Switzerland, besides the Russian territory of Kaliningrad is the only non-EU "island" within the EU. With a comparatively small population of 7.3 million, we are America's 6th leading trade partner and more direct investments of Switzerland in the US than Canada! The US is Switzerland's second largest export market, more important than neighbouring countries like France or Italy. Six hundred companies employ more than 500,000 people in the U.S. On the other side of the Atlantic, over 650 American companies are located in Switzerland and many have chosen Switzerland as their European headquarters. The latest being IBM.

Over the centuries, more than one million people of Swiss descent have made their mark on various aspects of American life. Some famous Swiss people include Louis Chevrolet, the founder of the automobile company; Jakob Amman, who established the Amish community; Bob Lutz, the famous auto industry manager or, more



recently, Academy Award-winning actress Renee Zellweger. Switzerland is known for its political neutrality, its base of the International Red Cross and the European seat of the United Nations, as well.

Coming from this small country to speak before the representatives and participants of one of the largest aviation markets in the world is a challenge on its own – but then, despite all the differences, there are some experiences and perspectives a CEO of Swiss International Air Lines can share with his US colleagues – especially those battling red ink on their balance sheets, because we still are making losses, despite enormous progress. Bob Crandall of AA once said: “If God would have meant man to fly, he would have made it profitable”. Of course I have no intention of telling anyone how to get out of it – there is presently only one Swiss person who can teach even the most accomplished American something – and that is Roger Federer. And, as you can see, I left my tennis racket at home!

My speech could be entitled in many different ways. One that takes into account both the Swiss airline and the Swiss tennis champion could be:

Swiss International Air Lines – or how to remain in the game in which the rules are changing every day

I want to describe the Swiss way of making consolidation possible in an industry which desperately needs it. Right after September 11th, the financial turmoil that has affected this industry has hit the Swiss aviation scene in an unprecedented way. It led to the financial



collapse of one of the world's most renowned airlines, Swissair, and we are still struggling to establish ourselves in the new market environment. The Swiss have had to learn the hard way how a failed strategy and the lack of timely countermeasures can lead to the demise of a company that used to be called the "the flying bank", because it was so wealthy. Within a period of less than five years it became an airline without a bank, a company burdened with a debt of about 10 billion USD. And since there is no Chapter 11, this finally drove it into receivership, bringing the entire fleet of Swissair to a grounding which shocked the world.

As the saying goes, every cloud has a silver lining, and in the past few years, my company that was built from the shambles of the former Swissair has embarked on a new future. But before I speak to you about this new future, let me once again look back.

After Swissair went under a debt moratorium, its subsidiary, Crossair, was severed from the company, got a new ownership and financing to become the new international and national carrier of Switzerland. Mainly for legal reasons it was impossible to retain the name Swissair. But then, everyone knew that Swissair did not go out of business because its product was bad, but rather because the expansion strategy of buying other small airlines had failed miserably. So the task was to find a business model which would enable SWISS to keep the excellent product it had, but with a very different structure, operating in an entirely different environment. The airline was no longer part of a large holding company consisting of almost 250 entities.



It became an airline, and nothing but an airline, with a streamlined network – half the old size – with a fleet of today 18 long-haul aircraft (Airbus 340 and 330) serving currently destinations in North and South America, Africa, the Middle East and Asia and 35 short-haul aircraft serving 42 destinations in Europe.

However, this downsizing brought about new challenges - how does one position a relatively small network carrier, operating out of a small country with a limited domestic market, which is way too little to provide enough customers for a profitable network carrier and an economy depending heavily on exports and tourism? In other words, an economy in which every other Swiss Franc is earned abroad.

The clear “raison d’être” of SWISS is to provide excellent connectivity to and from Switzerland. In the course of restructuring, SWISS had to give up over 20 of the intercontinental routes previously served directly from Switzerland. The same fate befell over 30 European routes. The European routes were subsequently taken over by other carriers, especially LCC, but only *one* intercontinental route – the one to Washington – was taken on by another carrier! This meant that passengers travelling from Switzerland to a destination outside Europe had to go via one of the other major European hubs. Companies like Air France, Lufthansa and British Airways immediately increased the number of flights between Switzerland and their hub, wooing business travellers in particular. SWISS had little power to counter these moves. It had not yet joined an alliance and without the support of a larger network, running the airline with a profit proved very difficult. A sustainable future depended on a close collaboration with a larger carrier. Although SWISS had quite a number of code shares at that



time and an even closer co-operation with American Airlines which had proven fruitful for both sides, it was clearly not enough to get out of the red ink.

These facts need not only intellectual understanding but also touch the heart and stomach feeling. Giving up national ownership affects pride, self-esteem, emotions and means leaving behind a long history of aviation.

It took the airline about three years to finally find the kind of partner to give it the option first to operate as a network carrier, secondly keeping its hub in Switzerland and third, being at the same time part of a larger network. In March 2005, Lufthansa and SWISS announced that SWISS would gradually become a fully-owned subsidiary of the Lufthansa Group, but maintaining its own brand, operating from Zurich under the oversight of Swiss Aviation Authorities. Presently, Lufthansa has acquired a 49% of shares in SWISS and the remaining 51% are held by a Switzerland based holding company. This step has meant that former large shareholders, including the Swiss government with its 20% stake, have had to trade their shares against an out-performance option of Lufthansa shares – and that was all. It is sad to say that their initial investment financially just paid off to a limited extent. But for the Swiss economy - and therefore their own businesses - the investment paid off. Core connectivity to the EU and to the world has been preserved. In Switzerland over 15 billion US dollars are generated by the aviation industry alone.

The future position of SWISS



The decision to make SWISS part of the German Lufthansa was not easy and it caused some mixed feelings in Switzerland, including its government – understandably so. Swissair and SWISS have always been associated with Switzerland and had been part of the national identity. More importantly, they guaranteed the country direct connections to places all over the world and for many international firms, first-rate accessibility is one of the reasons to choose Switzerland as their base. The Swiss were realistic enough to realize that SWISS, given the size of its fleet and of its market, could only secure its future with a stronger partner. In a country where a cross-country flight takes about 40 minutes, this inevitably means cross-border co-operation, a fact which also had led KLM to its integration into Air France. The two cases are similar: paradoxically, mid-size airlines from small countries can only maintain their standing as an individual brand with their own hub, if they become part of a larger airline. The often-cited structural reform of the aviation sector means trans-border cooperation, at least in Europe.

It was clear from the beginning that SWISS was to remain a mostly independent airline with its management and seat in Switzerland, its own fleet and crew, managed within the Lufthansa system as a profit center. SWISS would keep its own brand appearance, continue to develop its strengths as one of the best premium airlines worldwide, and expand its location advantages in the Swiss market. This includes a demand-driven international network of routes as well as an intercontinental hub at its base in Zurich. SWISS will therefore remain the national carrier of Switzerland and continue to stand for its values of hospitality, reliability and quality. We are proud of being regularly



elected the “best airline on the North Atlantic” by many business customers.

The move also made sense from a strategic point of view: Europe has three big hubs - London, Paris and Frankfurt - each dominated by one carrier. Lufthansa knew the limitations of its home-base Frankfurt which had led to the expansion of Munich as its second hub. It was feasible to add Zurich to this multi-hub strategy as the third hub, enabling Lufthansa to maintain a strong position in central Europe and retain a level playing field with its main competitors, Air France and British Airways.

Of course, like in any other industry, a merger or integration only makes sense if operations are streamlined and synergies are taken advantage of. At the end of the day, there must be an added value for the customer. The added value for SWISS and Lufthansa customers, especially those from Switzerland, means that they can use both airlines for their trips, combining the flights and knowing that, either way, they are getting a premium product at a competitive price. SWISS and Lufthansa will not only coordinate their network but customers will also have Miles&More as joint frequent flyer program, joint check-in facilities and easy transfers at all three hubs.

Last but not least, you have to remember that culturally the two companies have very similar backgrounds which of course, make the integration easier. In the coming year SWISS will become a member of the biggest and most successful airline alliance – the Star Alliance. In the course of this process we will gradually end our strategic partnership with AA and step into cooperation with United Air Lines.



This transfer is currently subject to an anti-trust approval process by the Department of Transportation.

Although, from a commercial point of view, the integration of SWISS into Lufthansa is a logical step, there are obstacles. Anti-trust issues needed to be addressed and clearances had to be obtained. A process initiated immediately after the take-over was announced and the most important clearances were obtained this summer.

Additionally we have another issue we will have to tackle. For the past 15 years, the international aviation market has seen an unprecedented liberalization in which the US has been a frontrunner. "Open Sky Agreements" have been negotiated and are the basis for restructuring the markets. Curiously enough, liberalization has stopped short of the issue of ownership and control, thus imposing severe limitations on the capital invested in airlines. It still ties such an investment to a nationality requirement. The traditional ownership and control clauses have prevailed in the Open Skies Agreements including those of the US and of many other countries, effectively precluding the trans-border cooperation and trans-border flow of capital in the aviation market. Of course, in a country with an economy the size of the US, such a limitation may not have the same consequences as for a carrier from a country with an economy the size of Switzerland or other smaller European countries. As mentioned before, due to these ownership requirements, Lufthansa currently owns 49% of the shares in SWISS through a Swiss holding company and will increase its share-holdings to 100% only once it has obtained the necessary clearances from foreign governments.



There are different ways to solve this problem. One of them would be to modify existing bilaterals and to replace the ownership and control requirement with a principal place of business clause. The other option would be to obtain a waiver from foreign governments, allowing a carrier like SWISS to continue to serve a specific route although it is owned by foreign nationals. In some countries it has proven to be quite difficult to get such a waiver, although in 2003 the ICAO Aviation Conference formally recommended its member states to introduce a principle place of business clause and delete the ownership and control requirement. Despite the fact that many authorities – this includes the US – have basically agreed that this change should take place, there seems to be a long way between the declaration and the implementation of a new policy. We do hope that the US authorities will lead the way because, especially in Asian countries, authorities tend to wait before they accept any new policy until other countries have shown that the world does not stop turning because of such a change.

As I said before, SWISS is dependent on becoming part of a larger network in order to remain an intercontinental carrier operating out of Switzerland. We want to ensure that there are direct intercontinental flights to and from Switzerland. And even when the shares of SWISS are wholly owned by Lufthansa, we want to be able to offer Roger Federer a direct flight if he travels to a tournament, including the US Open. And hopefully it won't be the tournament he plays against the *son* of André Agassi – we need it to happen much sooner!

Thank you for your attention.

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