

CASE 4-2 Iberia Airlines Builds a BATNA

MADRID—One day last April, two model airplanes landed in the offices of Iberia Airlines.

They weren't toys. The Spanish carrier was shopping for new jetliners, and the models were calling cards from Boeing Co. and Airbus, the world's only two producers of big commercial aircraft.

It was the first encounter in what would become a months-long dogfight between the two aviation titans—and Iberia was planning to clean up.

Airbus and Boeing may own the jetliner market, with projected sales of more than \$1 trillion in the next 20 years, but right now they don't control it. The crisis in the air-travel industry makes the two manufacturers desperate to nail down orders. So they have grown increasingly dependent on airlines, engine suppliers, and aircraft financiers for convoluted deals.

Once the underdog, Airbus has closed the gap from just four years ago—when Boeing built 620 planes to Airbus's 294—and this year the European plane maker expects to overtake its U.S. rival. For Boeing, Iberia was a chance to stem the tide. For Airbus, Iberia was crucial turf to defend.

Iberia and a few other airlines are financially healthy enough to be able to order new planes these days, and they are all driving hard bargains. Enrique Dupuy de Lome, Iberia's chief financial officer and the man who led its search for widebody jets, meant from the start to run a real horse race. "Everything has been structured to maintain tension up to the last 15 minutes," he said.

Throughout the competition, the participants at Iberia, Boeing, and Airbus gave *The Wall Street Journal* detailed briefings on the pitches, meetings, and deliberations. The result is a rarity for the secretive world of aircraft orders: an inside look at an all-out sales derby with globetrotting executives, huge price tags, and tortuous negotiations over everything from seats to maintenance and cabin-noise levels. The rivals' offers were so close that on the final day of haggling, Iberia stood ready with multiple press releases and extracted last-minute concessions in a phone call between the airline's chair and the winning bidder.

By that point, both suitors felt like they'd been through the wringer. "With 200 airlines and only two plane makers, you'd think we'd get a little more respect," said John Leahy, Airbus's top salesman.

Airbus, a division of European Aeronautic Defense & Space Co., reckoned it had a big edge. It had sold Iberia more than 100 planes since 1997. Leahy thought last summer that he might even bag the contract with minimal competition. In June he had clinched a separate deal with Iberia for three new Airbus A340 widebodies.

But Dupuy made Leahy fight for the order—and so enticed Boeing to compete more aggressively. Then, "just to make things interesting," Dupuy said, he upped the pressure by going shopping for secondhand airplanes. These are spilling onto the market at cut-rate prices as the airline industry's problems force carriers to ground older jets with their higher operating costs.

Iberia is one of the industry's few highly profitable carriers, thanks to a thorough restructuring before the national carrier was privatized in early 2001. The world's number 18 in passenger traffic, with a fleet of 145 planes, it has benefited by flying few routes

to North America, where air travel is in tatters, and by dominating the large Latin American market.

The Spanish carrier was looking to replace six Boeing 747-200 jumbo jets more than 20 years old. It wanted as many as 12 new planes to complete a 10-year modernization program for Iberia's long-haul fleet. Based on list prices, the 12-plane order was valued at more than \$2 billion.

Iberia's Dupuy, a soft-spoken career finance man, first needed to woo Boeing to the table. The U.S. producer had last sold Iberia planes in 1995, and since then, the carrier had bought so many Airbus jets that Boeing considered not even competing. But in late July, Dupuy met Toby Bright, Boeing's top salesman for jets. Over dinner in London, according to both men, Dupuy told Bright that Iberia truly wanted two suppliers, not just Airbus.

The Boeing sales chief was skeptical, and he recalled thinking at the time, "You're running out of ways to show us." Having worked as Boeing's chief salesman in Europe, Airbus's home turf, he had heard similar lines from customers who eventually bought Airbus planes. So he wondered: "Are we being brought in as a stalking horse?"

Yet replacing Iberia's old 747s with new 777s would be Boeing's last chance for years to win back Iberia. The argument against Boeing was that an all-Airbus fleet would make Iberia's operations simpler and cheaper. Still, going all-Airbus might weaken Iberia's hand in future deals. Airbus would know that the carrier's cost of switching to Boeing would require big investments in parts and pilot training.

In early November, Airbus and Boeing presented initial bids on their latest planes. The four-engine Airbus A340-600 is the longest plane ever built. Boeing's 777-300ER is the biggest twin-engine plane.

The new A340 can fly a bit farther and has more lifting power than the 777. The new Boeing plane is lighter, holds more seats and burns less fuel. The Boeing plane, with a catalog price around \$215 million, lists for some \$25 million more than the A340.

Dupuy, whose conference room is decorated with framed awards for innovative aircraft-financing deals, set his own tough terms on price and performance issues including fuel consumption, reliability, and resale value. He wouldn't divulge prices, but people in the aviation market familiar with the deal say he demanded discounts exceeding 40 percent.

As negotiations began, Dupuy told both companies his rule: Whoever hits its target, wins the order. The race was on.

Bright, who had been appointed Boeing's top airplane salesperson in January 2002, pitched the Boeing 777 as a "revenue machine." He insisted that his plane could earn Iberia about \$8,000 more per flight than the A340-600 because it can hold more seats and is cheaper to operate. A burly 50-year-old West Virginian, Bright joined Boeing out of college as an aerospace designer. He knew the new Airbus would slot easily into Iberia's fleet. But he also felt that Dupuy's target price undervalued his plane.

At Airbus, Leahy also fumed at Iberia's pricing demands. A New York City native and the company's highest-ranking American, he pursues one goal: global domination over Boeing. Last year he spent 220 days on sales trips.

To Iberia, he argued that his plane offered a better investment return because the A340 is less expensive to buy and is similar to Iberia's other Airbus planes. From a hodge-podge of 11 models in 1997, Iberia now flies five types, and replacing the old 747s with A340s would trim that to four—offering savings on parts, maintenance, and pilot training.

Even before presenting Airbus's offer, Leahy had flown to Madrid in October to make his case. On November 18, he once again took a chartered plane for the one-hour flight from Airbus headquarters in Toulouse, France, to Madrid. For two hours that evening, he and his team sat with Dupuy and other Iberia managers around a table in Dupuy's office, debating how many seats can fit on a 777. Those numbers were crucial to the deal because each seat represents millions of dollars in revenue over the life of a plane but also adds weight and cost.

Boeing had told Iberia that its 777 could hold 30 more seats than the 350 Iberia planned to put on the Airbus plane. Leahy argued that the Boeing carries at most five more seats. "Get guarantees from Boeing" on the seat count, Leahy prodded the Iberia managers.

At Boeing, Bright was eager to soften Iberia's pricing demand. His account manager, Steve Aliment, had already made several visits to pitch the plane, and in late November, Bright sent him once again to protest that Iberia didn't appreciate the 777's revenue potential. Boeing desperately wanted to avoid competing just on price, so Bright pushed operating cost and comfort.

On the Airbus side, Leahy also was feeling pressured because a past sales tactic was coming back to haunt him. In 1995, when Iberia was buying 18 smaller A340s and Dupuy expressed concern about their future value, Leahy helped seal the deal by guaranteeing him a minimum resale price, which kicks in after 2005. If Iberia wants to sell them, Airbus must cover any difference between the market price of the used planes and the guaranteed floor price.

The guarantee is one of the tools that Leahy has used to boost Airbus's share of world sales to about 50 percent today from 20 percent in 1995. Boeing rarely guarantees resale values.

Dupuy had wanted guarantees because they lower his risk of buying and thus cut his cost of borrowing. What mattered now was that the guarantees also freed him to sell the planes at a good price. Early in the competition, he suggested to both Airbus and Boeing that he might eventually replace all of Iberia's A340s with Boeings—and potentially stick Airbus with most of the tab.

"If we didn't have the guarantees, the position of Airbus would be very strong," Dupuy said in an interview. Instead, "we have a powerful bargaining tool on future prices."

On December 4, Leahy flew again to Madrid to try to persuade Iberia to close a deal by year's end. Running through a presentation in Dupuy's office, Leahy and five colleagues ticked off fuel and maintenance costs for their plane. They asserted that passengers prefer the plane because it is quieter than the 777 and has no middle seats in business class.

Dupuy then rattled Leahy's cage with a new scenario: Iberia managers would be flying off next week to look at used Boeing 747-400 jumbo jets. Singapore Airlines had stopped flying the planes and was offering to lease them at bargain prices.

Leahy chided Dupuy, saying that was "like buying a used car," where a bargain can easily backfire. Dupuy replied that sometimes buying used makes sense because it offers the flexibility of other options. The message: Iberia could dump its Airbus fleet.

Within Iberia, another debate was ending. Dupuy heard from his managers the results of a yearlong analysis of the rival planes.

The Airbus was cheaper than the Boeing, and the A340's four engines help it operate better in some high-altitude Latin American airports. But Iberia managers had decided they could fit 24 more seats on the Boeing, boosting revenue. And Iberia engineers calculated that the 777 would cost 8 percent less to maintain than the A340. Maintenance on big planes costs at least \$3 million a year, so the savings would be huge over the life of a fleet.

Unaware of Iberia's analysis, the Boeing team arrived in Dupuy's office on the morning of December 11 with three bound selling documents. One contained Boeing's revised offer, titled "Imagine the Possibilities . . . Iberia's 777 Fleet." Knowing Dupuy as a numbers guy, the Boeing team peppered him with data showing passengers would choose Iberia because they prefer the 777.

Dupuy told the salespeople their price was still too high.

By mid-December, Iberia chairman Xabier de Irala was getting impatient and wanted a decision by the end of the year. On December 18, Boeing's Bright flew to Madrid. Over a long lunch, Dupuy reiterated his price target.

"If that's your number, let's give this up," Bright said. Talks continued cordially, but the men left doubtful they could close the gap. That Friday, December 20, Dupuy told Iberia's board that prices from Airbus and Boeing were still too high, and he would push the used-plane option harder.

By the start of the year, Airbus's Leahy, growing frustrated, arranged a Saturday meeting with Dupuy. On January 4, the Iberia executive interrupted a family skiing holiday in the Pyrenees and drove two hours along winding French roads to meet Leahy for lunch.

Leahy spent four hours trying to convince Dupuy and a colleague that Airbus couldn't offer a better deal. Dupuy argued that Airbus had just given steep discounts to British airline easyJet, so it should do the same for Iberia. Annoyed, Leahy said media reports of a 50 percent price cut for easyJet were nonsense.

"You get Boeing to give you a 50 percent discount and I'll send you a bottle of champagne," he told the Iberia executives.

Bright was frustrated too. In the first week of January, Dupuy proposed visiting Seattle, where Boeing builds passenger planes. Bright's reply: If Iberia was unwilling to budge, there was little reason to come. So when Dupuy said he would make the 14-hour journey, Bright was encouraged.

On January 14, Dupuy and two colleagues arrived in Seattle. In the private dining room of Cascadia, a high-end downtown restaurant, they met for dinner with the Boeing salespeople and Alan Mulally, the chief executive of Boeing's commercial-plane division. Dupuy was impressed by Mulally's eagerness and was pleased when he urged Bright's team to find a way to close the gap.

The next day, the Boeing salesmen offered a new proposal—including a slightly lower price, improved financing and better terms on spare parts, crew training, and maintenance support from General Electric Co., the maker of the plane's engines.

When Dupuy left Seattle on January 16, Bright felt Iberia was relenting a bit on price and that Dupuy wanted to "find a way to do the deal." Dupuy was also optimistic about striking a deal with Boeing.

Back in Madrid the next day, he raced off to join Iberia's chairman Irala for a meeting with Leahy and Airbus President Noel Forgeard. Irala, a bear of a man who is credited with saving Iberia from bankruptcy eight years ago, told the Airbus executives that Dupuy's price target remained firm. When the Airbus men relented on a few points, Irala yielded a bit too and spelled out Iberia's remaining targets for Airbus. Forgeard said a deal looked possible.

As the meeting broke up, Dupuy was pleased. He felt that Boeing and Airbus were digging deep. And no wonder. The world air-travel market was sinking deeper, and fears of war in Iraq and terrorism had slashed global bookings.

In the next few days, the sales teams from Boeing and Airbus each huddled to refine their offers. Both remained about 10 percent above Dupuy's price targets. Each called him several times daily, pushing for concessions. Dupuy didn't budge. On January 23, he told Iberia's board that both companies could do better. The board scheduled a special meeting for the following Thursday, January 30.

Energized by the Seattle meetings, Bright pushed his team "to go all out to win this bid," and they worked around the clock. Bright phoned Dupuy daily from Seattle and occasionally fielded his calls at 3:00 a.m., Pacific time. By late January, Boeing had cut its price by more than 10 percent after haggling over engine price with GE and financing with leasing firms. The 777 was now less than 3 percent above Dupuy's target—so close that Mr. Bright asked for a gesture of compromise from Iberia.

Dupuy was impressed by Boeing's new aggressiveness. But Airbus was also closing the gap so quickly, he said, that he could offer no concessions. To Leahy, he talked up Boeing's willingness to deal. "I was just talking to Toby . . .," Dupuy told Leahy during several conversations, referring to Bright. Airbus improved its offer further.

On Wednesday, the day before the deadline, Boeing and Airbus were running about even. In Seattle, Bright threw some clothes in his briefcase and proposed to Dupuy that he hop on a plane to Madrid. Dupuy said the choice was his, but what really mattered was the price target. That day, Dupuy told Bright and Leahy that their bosses should call Irala with any final improvements before the board meeting.

On Thursday morning, Bright offered to trim Boeing's price further if Dupuy could guarantee that Boeing would win the deal. "I can't control Forgeard," Dupuy replied, referring to the Airbus president, who was due to talk soon with Irala. Bright made the price cut without the concession.

"You're very close," Dupuy told him.

Later, Forgeard got on the phone with Iberia's Irala, who said he still needed two concessions on the financial terms and economics

of the deal. Airbus had already agreed to most of Dupuy's terms on asset guarantees and, with engine maker Rolls-Royce PLC, agreed to limit Iberia's cost of maintaining the jets. Forgeard asked if re-lenting would guarantee Airbus the deal. Irala replied yes, pending board approval—and looked over with a grin at Dupuy, who sat nearby with his laptop open. Forgeard acquiesced. Dupuy plugged the new numbers in his spreadsheet. Airbus had hit its target.

That evening, Boeing got a call from Iberia saying the airline would soon announce it had agreed to buy nine A340-600s and taken options to buy three more. Hours later, Boeing posted on its Web site a statement criticizing Iberia's choice as "the easiest decision." Bright said later that he simply couldn't hit Dupuy's numbers and "do good business."

In the end, Airbus nosed ahead thanks to its planes' lower price and common design with the rest of Iberia's fleet. By offering guarantees on the planes' future value and maintenance costs, plus attractive financing terms, Airbus edged out Boeing's aggressive package. The deal's final financial terms remain secret.

At Airbus, Leahy was relieved, but he faced one last slap. Iberia's news release crowed about Airbus's price guarantees on the planes—a detail Leahy considered confidential. Iberia's Dupuy said he wasn't rubbing it in. But he had, he boasted, won "extraordinary conditions."

QUESTIONS

1. Critique the negotiation strategies and tactics of all three key executives involved: Dupuy, Leahy, and Bright.
2. Critique the overall marketing strategies of the two aircraft makers as demonstrated in this case.
3. What were the key factors that ultimately sent the order in Airbus's direction?
4. Assume that Iberia again is on the market for jet liners. How should Bright handle a new inquiry? Be explicit.

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