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Trying to operate more than one business model at a time is devilishly difficult—and frequently cited as a leading cause of strategic failure. Yet situations abound where a company may wish or need to address several customer segments, using a particular business model for each one. To crowd out competitors or forestall potential disruptors in its current markets, to expand into new markets, to make more efficient use of fixed assets and other resources, or to develop new income streams may all ideally require distinct business models that operate in tandem.

IBM and Compaq, for instance, supplemented their reseller distribution model with a direct-sell model to counteract Dell's growth in the 1990s. Netflix runs two business models for its DVD-by-mail and its streaming-video services. In emerging markets a bank sometimes creates a separate company to offer credit to low- and middle-income customers, as Banco Santander-Chile has done with Banefe. The forestry company Celulosa Arauco turns its trees into paper pulp under one business model and into wood panels for high-end furniture under another.

PHOTOGRAPHY: JOHN MULDERS

Nowhere have the perils of running tandem business models been more evident than in the airline industry, where so many full-service carriers have met with so little success in introducing no-frills offerings to compete with low-cost competitors such as EasyJet and Southwest. Witness what happened to British Airways' Go Fly, Continental Lite, KLM's Buzz, and Delta's Song.

That's what makes the case of LAN Airlines, which successfully operates three business models at once, so remarkable. The Chilean carrier has thrived by integrating a full-service international passenger-airline business model with an air-cargo business model while separately operating a no-frills passenger model for domestic flights. In fact, the word "thrived" is too modest: From 1993 to 2010, LAN posted 17% compound annual revenue growth through good times and bad (from $318 million in 1993 to $4.2 billion in 2010), while steadily raising annual net profits from zero to $420 million. LAN's market capitalization, at $8.9 billion as of March 11, 2011, exceeds that of most of its main global rivals—US Airways ($1.5 billion), American Airlines ($2.2 billion), Korean Air ($3.7 billion), British Airways ($6.9 billion), and United-Continental ($8.1 billion). It even tops that of upstart Ryanair ($6.9 billion) and every other Latin American airline. From 1998 to 2010 LAN's share price, adjusted by dividends and splits, has grown by more than 1,500%.

LAN Airlines has succeeded where its rivals have not through a more subtle appreciation of the way different business models relate to one another. Certainly, many business models conflict, as in Netflix's high-profile case. Others, like the models for digital and film photography, are clear substitutes for each other. No doubt such models should be operated separately, and perhaps, only sequentially.

As LAN Airlines' experience makes clear, however, other business models are complementary. Indeed, they may be so mutually reinforcing that together they turn otherwise unviable possibilities into profitable opportunities. A company that recognizes which models are substitutes that must be kept separate and which are complements that strengthen each other can build a uniquely sustainable competitive advantage. Let's look at how LAN has used that insight to its benefit.

How LAN's Three Models Interrelate

LAN operates its full-service international passenger-carrier business in much the same way as other global carriers do. It offers frequent flights to major destinations through its own hubs and via alliances with other airlines. It has two classes (coach and business) of amenity-filled service, featuring complimentary hot meals and beverages, multilingual personal-entertainment units in coach, and fully flat beds in business class. Likewise, its no-frills domestic operation has essential elements in common with Southwest's and Ryanair's: It is a lower-cost, lower-overhead model characterized by fewer amenities, internet ticketing, shorter turnaround times, and a uniform fleet of single-aisle planes from which the kitchens have been removed to increase seating capacity.

What sets LAN apart is its cargo business—a premium service like its international passenger operation. It transports salmon from Chile, asparagus from Peru, fresh flowers from Ecuador, and other such perishables to the U.S. and Europe while flying high-value-to-weight merchandise such as computers, mobile phones, and small car parts from the U.S. and Europe to Latin America.

LAN is unusual among passenger carriers in its reliance on cargo revenue—accounting, by the second quarter of 2011, for 31% of its total revenue (compared with less than 5% for American, Delta, and United-Continental). Although Korean Air and Cathay Pacific both also derive about a third of their revenue from cargo, LAN is distinctive in that it transports fully 35% of its shipments in the belly of wide-body passenger aircraft, which serve most of its cargo destinations. In fact, the bulk of LAN's cargo business operates on the same route network with its passenger business.

In all three of LAN's models, the key to profitability is the same: flying more planes, more fully loaded, to more places. However, when LAN set out in 2007 to introduce no-frills flights on domestic routes, it knew it could not do that by combining passengers and cargo on those routes. The goal was to increase profitability and preempt the threat from some Latin American version of Ryanair or Southwest, initially on flights within Chile and Peru and later on routes to Argentina, Ecuador, and Colombia.

Some complementary business models may be so mutually reinforcing that together they turn otherwise unviable possibilities into profitable opportunities.

But on the one hand, demand for air-cargo transport was far lower in domestic markets than it was internationally, given that goods could instead be carried by truck, train, or boat. What's more, its local markets generated little demand for the perishables that LAN was transporting farther abroad. And perhaps most critically, the narrow-body aircraft used on the short-haul routes were not big enough to carry sufficient cargo.

On the other hand, passenger demand for LAN's domestic air travel is highly elastic: By lowering fares on short-haul routes by 20%, LAN could attract up to 40% more passengers, enabling it to invest in newer, more efficient planes, which could fly more hours per day. The implication was that the most direct (perhaps the only) way to increase capacity utilization for domestic flights was with low fares, made possible solely by offering a basic level of service to drive down costs.

This logic has been borne out, as lower fares have led to dramatic increases in demand: From 2006 to 2010, the number of passengers on LAN's domestic flights increased 83% within Chile, 123% in Peru, and 200% in Argentina, allowing LAN to reach its goal of increasing aircraft utilization on its short-haul routes from eight to 12 hours a day. LAN now holds the largest market share of passenger traffic within Chile and Peru and is increasing its market share in other South American countries.

LAN also has the largest market share of passenger traffic to and from Chile, Peru, and Ecuador, as well as approximately 37% of the Latin American air-cargo market, as its complementary full-service passenger and cargo operations have yielded many mutually reinforcing advantages. These include:

Maximal use of physical assets. Consider the following example: A LAN flight from Miami arrives in Santiago, Chile, at 5:00 AM. It continues to another Latin American city, say Bogotá, Lima, or Buenos Aires, to deliver cargo from the U.S. Then it returns to Santiago to fly customers back to Miami or New York, because passenger flights to the U.S. from South America are at night. Meanwhile, competitors with no cargo operation are forced to park their aircraft at Santiago's airport for most of the day. The advantages of increased utilization of as costly an asset as a wide-body aircraft are easy to see.

Reduction of the break-even load factor (BELF). By combining cargo and passenger operations, LAN can profitably fly where other airlines cannot, because the number of passengers or amount of cargo it needs to break even on each flight is lower than if LAN were transporting only one or the other. In 2010, for instance, the BELF percentage for LAN's Santiago-Miami route would have been 68% if the aircraft had flown only passengers, but transporting cargo as well lowered it to 50%. What's more, without cargo, LAN's Santiago-Madrid-Frankfurt route, to take just one, would have terminated in Madrid, because going on to Frankfurt is not profitable when carrying only passengers.

Diversification of revenues and profits. By transporting both cargo and passengers, LAN can keep flying routes profitably when demand falls, as the two businesses seldom dip to the same degree in tandem. Even in the depths of the Great Recession in 2009, when cargo demand was down 10.1%, passenger travel dropped by only 3.5%. So LAN did not have to contract operations as much as its cargo-only competitors did, and it consequently was ready the next year to take advantage of renewed demand that those carriers could not accommodate.

Reduced threat of entry by other airlines. As LAN increases the number of routes it serves, it decreases the probability that other carriers can profitably enter into its markets.

One-stop shop for cargo in Latin America. The ability to fly more routes profitably creates a virtuous circle. More routes mean more value for customers, enabling LAN to charge premium prices, thereby generating revenue to support even more routes and to eventually become the one-stop shop for cargo distribution in Latin America. (See the exhibit "How Two Business Models Complement Each Other.") The rock group The Police, for instance, used LAN to transport a stage show that filled two jumbo jets for an eight-concert Latin American tour. Less exotic clients, such as smartphone and computer hardware makers, have proven similarly willing to pay a premium for the convenience of having a single company handle all their shipping needs in Latin America.

The Challenge of Managing Multiple Models

Why doesn't every airline do what LAN does? Part of the answer is historical: The Cueto family, one of the two groups that purchased LAN when the Chilean government fully privatized it, in 1994, had begun in the cargo business with Fast Air during the 1970s. So the family knew the business well and could readily see, in the context of a combined cargo and passenger service, the profit potential of LAN's international routes, its wide-body aircraft, and its reputation for reliability.

But to recognize the potential and to capitalize on it are two different things. To say that two models complement each other is not to say that combining them is easy. In fact, the learning curve can be steep, favoring those, like LAN, that climb it first. Among LAN's chief challenges in combining its cargo and international passenger models, while keeping its low-cost model separate, were these:

Additional complexity. To plan for both businesses, LAN must dynamically coordinate a sophisticated passenger-yield management system, which raises and lowers ticket prices to manage demand levels, with an active cargo-capacity management system that similarly varies rates on cargo. LAN also needs to assign that cargo optimally to either the passenger or the freight planes, which it does through a complex logistics system that coordinates cargo and passengers. Given that both divisions are profit centers, possible conflicts must be managed carefully. Therefore, LAN has imposed an additional criterion for passenger fares that its global long-haul competitors do not need: The lowest passenger fare must be at least as large as the revenue that LAN would obtain if the weight burden of the passengers were allocated to cargo. In this way, LAN gives priority to carrying people in its wide-body passenger aircraft but also ensures that the minimum passenger fare covers the cost of cargo of similar weight.

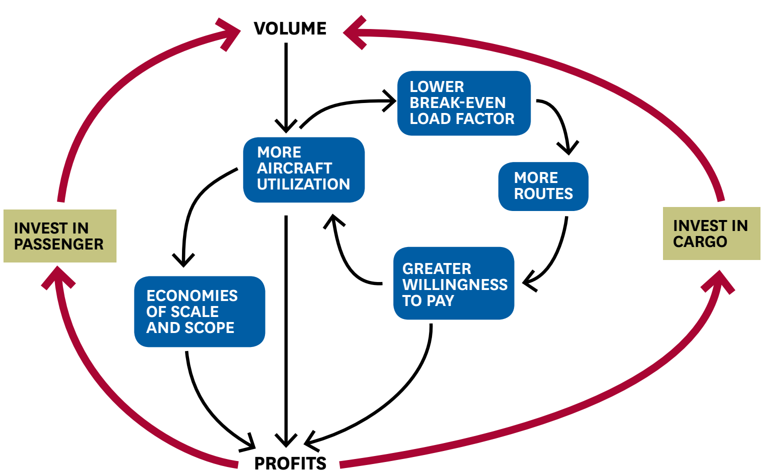
Broader organizational skills. LAN's three businesses require different sales and marketing efforts and a sometimes mind-boggling variety of technical skills to maintain its premium services. For instance, at the same time that LAN was extensively training its flight and maintenance crews for its passenger business (ultimately winning it several awards for service), it needed to train employees in how to care for pigs and horses in its cargo-only planes.

Greater employee flexibility. Flying more planes to more places means that LAN's pilots must fly even on two hours' notice, half the time typical for a U.S. legacy airline. That would not be possible if LAN had not created a culture that fosters flexibility by instituting a performance-related pay and bonus structure, both for management and for administrative and flight personnel. Notably, though, in 2010 LAN's wages were a lower percentage of its total costs relative to the percentage at many U.S. and European carriers.

Additional investments. No two business models share all resources, of course. In Miami, for example, where LAN's cargo operations are headquartered, the company has almost 500,000 square feet of dedicated warehouse space and other cargo facilities that its passenger competitors do not need. Furthermore, to serve Latin America comprehensively, regulatory constraints preventing non-national companies from operating within certain countries have impelled LAN to create a series of separate companies for its no-frills short-haul passenger service: LAN Peru, LAN Ecuador, LAN Colombia, and LAN Argentina. It has also set up additional operating structures through alliances in Mexico and several other countries.

HOW TWO BUSINESS MODELS COMPLEMENT EACH OTHER

Simultaneous investment in LAN Airlines' passenger and cargo businesses creates a virtuous circle by increasing volume and aircraft utilization, which decreases the break-even load factor and increases the attractiveness of new routes. Adding more routes leads to greater economies of scale and scope, boosts customers' willingness to pay, and increases revenues and profits—thereby providing a funding source for further expansion.



Distinguishing Complements From Substitutes

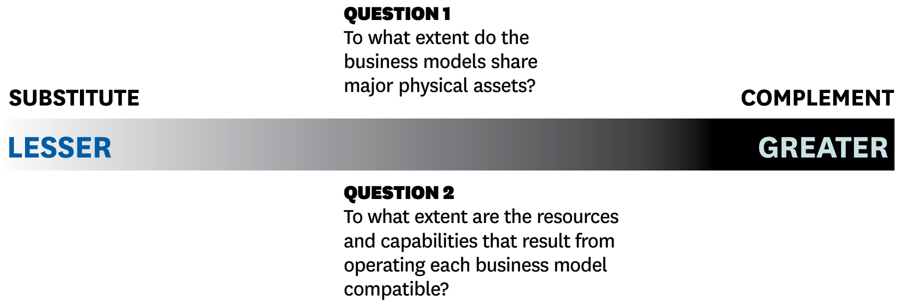
Operating three business models is clearly not without its risks—but meeting the challenge offers uniquely sustainable benefits. LAN was able to minimize the risks and capture the benefits by combining two complementary models and carefully keeping a competing model separate. But how did it tell which was which?

Our analysis suggests that to determine whether two business models are complements or substitutes, executives should consider two questions:

- To what extent do the business models share major physical assets?

Are Your Business Models Complements or Substitutes?

Business models are more likely to be complements rather than substitutes—and to generate greater value together than apart—if, when you consider these two questions, your answers fall closer to the right side of the spectrum than to the left.



• To what extent are the resources and capabilities that result from operating each business model compatible?

The greater the number of critical assets the models share, and the greater the number of shared capabilities and resources that result from the operation of the models, the more likely that combining the two models will yield a more valuable result. (See the exhibit "Are Your Business Models Complements or Substitutes?")

In LAN's case, the major physical assets are its wide-body planes, which the cargo and international passenger models share but the low-cost domestic operations do not. Equally critical is the cascade of advantage-enhancing resources and capabilities produced by combining the cargo and full-fare passenger models:

• Decreasing the break-even load factor by combining cargo and passengers, thereby allowing LAN to fly to more places, creates value in both businesses and, thus, expands LAN's markets and revenues.

• Using the growing revenues provided by cargo operations to underwrite better service to passengers and vice versa further increases customers' willingness to pay for both offerings.

• Flying to more places makes it harder for other airlines to enter and grow in the Latin American market for *either* cargo *or* passengers, which sustains LAN's advantage.

• The skills that LAN has had to develop to optimize the use of aircraft and the network of routes for both passengers and cargo have further increased barriers to imitation in both markets.

• LAN has become the leading passenger airline connecting Latin America to the rest of the world and *the* one-stop shop for cargo in the region. That increases switching costs for cargo customers and convenience for passengers, further boosting demand for both passenger and cargo service and thereby strengthening LAN's advantage.

LAN's low-cost domestic business does share in some of those capabilities and resources—the skills developed to efficiently schedule flights and maintain aircraft, the flexibility of its workforce, its understanding of the regulatory requirements for its various Latin American operations, and its capacity to fly customers and cargo to, from, and within Latin America. But LAN's critical physical assets can't be shared, and most of the capabilities and resources essential to the domestic operation—the brand, the reputation for low fares, the emphasis on efficiencies to lower costs—conflict with those of a premium, higher-cost offering. Those realities dictate that LAN operate the no-frills model separately.

LAN teaches its crews to provide award-winning passenger service while training employees to care for pigs and horses on its cargo-only planes.

IT'S FAR RARER for two business models to have *critical* assets, capabilities, and resources in common than not. That fact no doubt contributes both to the high failure rate of companies that use more than one model at a time and to the sense that firms that even contemplate running multiple models do so at their own risk.

But the lesson of LAN Airlines points to another form of risk—for LAN's competitors. By mastering three models—and by deeply understanding how complementary models generate unique opportunities—LAN has built, in both passenger and cargo service, formidable competitive advantages that are becoming increasingly difficult for competitors to overcome.

LAN's competitive advantage in international passenger service would vanish if the company did not have a thriving cargo business; likewise, its advantages in cargo would not exist without a blooming passenger business. Competitive strategy is all about building advantage by protecting a unique position and exploiting a distinctive set of resources and capabilities. Viewed in this light, the implementation of multiple business models is not a risk but rather a new tool for strategists. Properly applied, it will help firms boost their ability to create and capture value—and to gain durable advantage.

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