Tallink: Connecting Estonia to Finland, Sweden and Russia.

Introduction

Tallink is an Estonian Shipping Company servicing passengers and cargo in Estonia, Finland and Sweden. Currently, Tallink faces diverse issues ranging from internal/firm specific to larger institutional and political impact concerns. These include replenishing older ferries, assessment of future prospects and route offerings to entering the Russian market, Estonia's impending union with the EU and future competition. In this report, a comprehensive analysis along with a unique strategy solution in the context of International Business will be presented to address the problem for Tallink.

Situational Analysis

As Estonia's sole Ferry Company, one of the most apparent strength of Tallink lies in its ties to the state, potential for joint ventures and support. Similar to the Ontario 407 Highway or the Rail transport in Japan, governments are spurred by interests of servicing public debt, trade deficits and export opportunities presenting an opportunity to partner with the Estonian government. Some of these may include investment, subsidies and national tourism promotion deals. In addition, a clear strength in Tallink's current position is its attractive onboarding sales ranging from restaurants, entertainment and most significantly- Duty free offerings on Tobacco, Alcohol and Perfume among other items. Finally, its prime location into Eastern Europe must be considered in context with the underdeveloped tourism and shipping infrastructure. Some of the Limitations of Tallink exists in its aged and archaic fleet. With 5 of 8 ships currently 20 years or older, maintenance and inefficiency can hurt long term value. From an Institutional view, the major apparent weakness is its non-membership with the

European Union- resulting in additional costs driven by fees, entrance barriers with major steel suppliers (Luxembourg, East Asia) and clients enjoyed by EU members. Despite its obstacles, Tallink is uniquely positioned to capitalize on the growth of tourism throughout Eastern Europe. European spenders are not only attracted by Estonia along with its duty free shopping, but by the historical and cultural sites offered by Eastern Europe and Russia. Opportunities for growth in the industry in this perspective can be secured through additional route offerings, creating non EU member partnerships to facilitate entrance procedures and public-private partnerships. With Labor laws in Western Europe one of the most generous in vacation and paid leave, there is greater potential in the growth of Tourism in Eastern Europe. Some of the risks inherent to Tallink are the risk of loss with launching MS Romantika's sister ship planned for Stockholm. Other threats such as Russia's policies to non CIS (Commonwealth of Independent States) members becomes difficult in addition to lack of tourism infrastructure in routes to St. Petersburg. A threat we must also address are the major competitors of shipping services- Nordic Jet Line, Viking Line and Silja Line. Nordic Jet Line focuses on higher speed catamaran ships while Viking and Silja lines have larger and comparable shipping and cargo fleets respectively.

Throughout this report, each of the mentioned situational facets will be further analyzed to identify and evaluate the best course of action.

Assumptions

This report's analysis and findings are written in the context of the case "Tallink: Connecting Estonia to Finland, Sweden and Russia". This investigation is written in the perspective of the strategy decision in 2002. Firm specific data are extracted from the case appendix and data from primary and secondary sources in 2002.

Problem

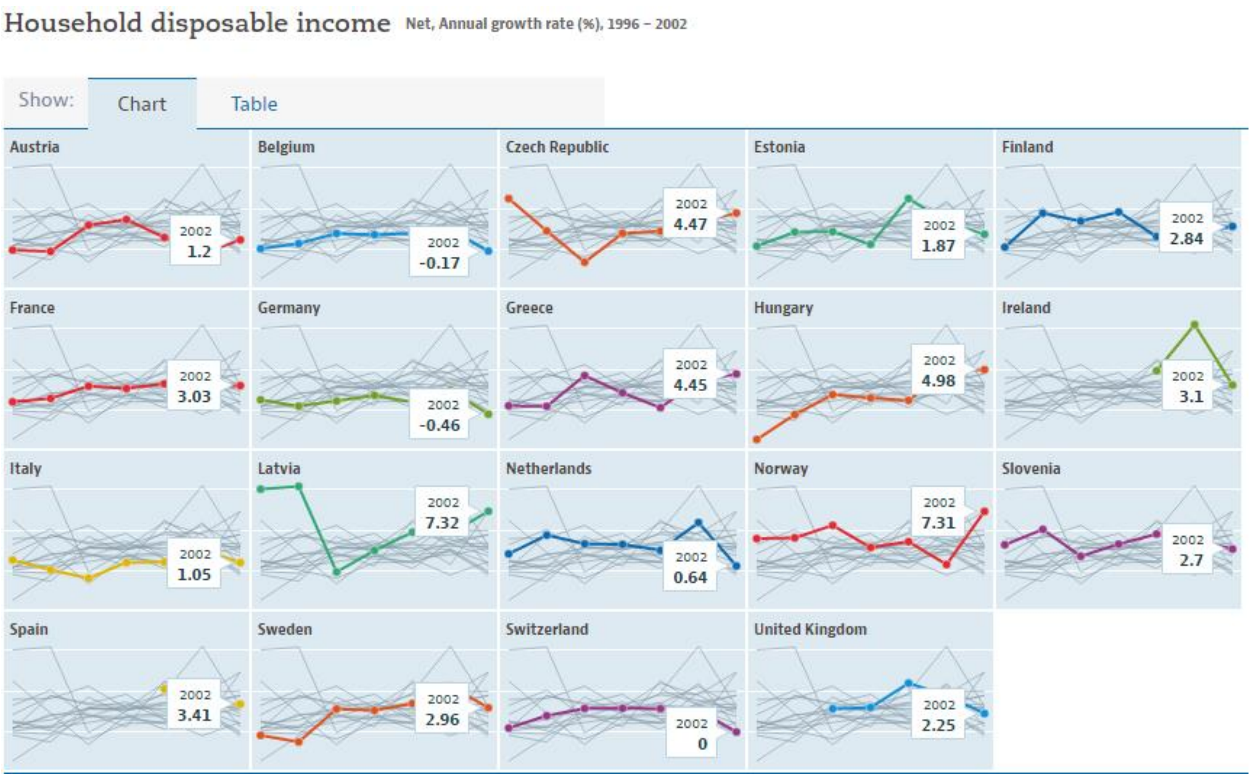
Applying the SWOT analysis, it is clear Tallink is positioned to lead the shipping and cargo industry. However, with its current business model how will it overcome its risks and competitive forces? What steps must be taken to ensure long term growth and sustainable profitability? Should the investment of a sister ship to MS Romantika be made? Furthermore, should Tallink shift towards higher speed vessels with higher volumes of service or provide further routes and stops to capture additional onboard revenue? In this report, we will address these questions given its political and situational climate and provide a solution to the problem defined as Tallink's medium and long term strategy (5- 20 years).

Analysis & Application

Industry Climate & Analysis

The Shipping and Cargo industry environment is affected by many factors. One major factor is travel seasonality. During the summer (June-Mid August), travelling is popular with European consumers while during winter tourism and travel are understandably unpopular. Other important considerations include disposable income and the cost of travel. Currently, Economic climate in Europe has been favorable with GDP growth at almost 3% and healthy growth of disposable income, varying between 1-7% according to OECD. Combined with a decline in unemployment the past 3 years of an average of

0.5% and growth of Consumer spending by 13%, tourism and travel in Europe are poised to have an accelerated expansion.



In this industry, travel service, cargo shipping along with onboard shopping and entertainment are the primary sources of Revenue. Varied by distance travelled, type of ferry and the amenities, a shorter journey from Tallinn to Helnski ranges between 35 to 40 Euros, while a larger distance of Tallink to Stockholm varies between 75-80 Euros with a standard Ferry. The price per km travelled is not linear, as longer boarding time leads to further consumption, resulting in the offset of fuel costs. As a result, ticket pricings are reflective of the offerings onboard.

Cost Structure

The cost structure is largely dependent on Fuel and Staffing costs. Varied by the distance travelled and the efficiency of the boat, the fuel costs can range between 25-40% of the cost of Sales for medium (Tallink to Hellinski, St Petersburg) and long distance (Tallink to Stockholm). Staffing costs represent one of the largest costs in this industry ranging from 35-40%. Staffing covers a diverse array of activities from Maintenance and Crew to restaurants, bars and entertainment. Concerns facing this industry is the rise of Labor costs, (3-4%), limited and high turnover labor force. According to Eurostat, temporary positions and part time work are common in the Tourism industry, leading to higher turnovers to other industries. In addition, Crude Oil prices are an important driver in this industry we must consider. Dating back to 1990 and Hussein's Invation of Kuwait and China's increased demand for oil, oil has been steadily rising with the exception of a few outliers. Currently at $22 USD/barrel, it is forecasted to increase at an average of 9% a year. As a result, this is added pressure in the investment/refresh decision of newer ships as most of the 8 Ferries are inefficient high consumption ships.

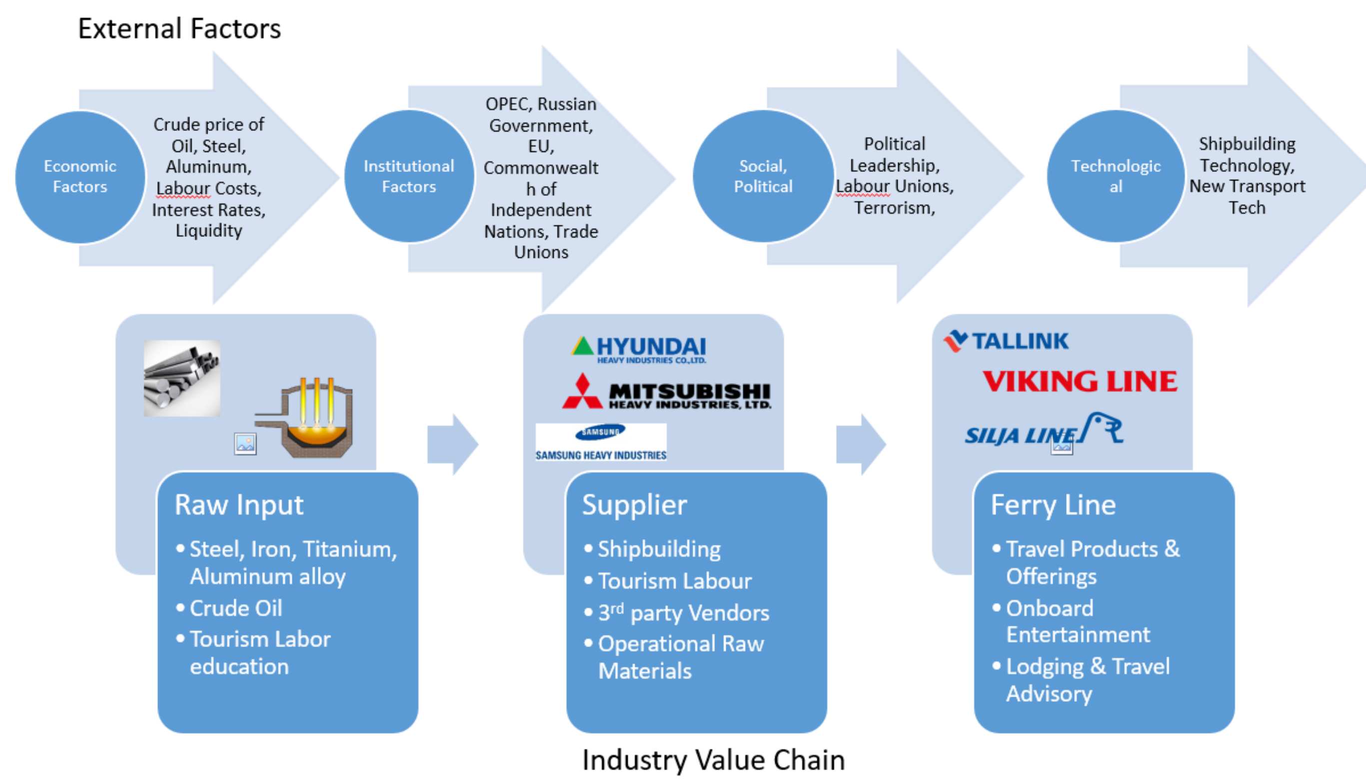
Further Industry analysis- Porter's Five Forces

Entrance in this industry is very difficult due to the high upfront capital investment and regulation requirements. With Ferries comparable to Tallink and Silja line in excess of $100 million each, the heavy investment along with compliance on cross border shipping licenses and other regulation deters entrants substantially. Suppliers in this industry consist of the major ship builders located in South Korea and Japan as well as skilled laborers in Europe. Currently possessing 80% of Ship construction market share in the world, Hyundai Heavy Industries, Mitsubishi Heavy Industries and a handful of other suppliers in East Asia are the primary suppliers of Ships in 2002. As a result, while these suppliers have significant influence in this industry, they are swayed by raw material prices such as Steel and Iron. Buyer Power in this industry are relatively low- Due to the few options available and scattered route offerings (Silja and Tallink – Stockholm, Finland and Estonia, Nordic Jet line in Norway). While B2B clients in cargo shipping can exert some buyer power, consumers are most often commercial customers with small purchases. As a result, there is little buyer power in this industry. Most concerning area in this industry is the threat of substitutes. Comparing the low cost air travel providers to Ferry travel in Figure 1 it is much less time consuming to travel by Air with only a slight increase in cost- on average 20 Euros per trip, with a similar number of flights offered per week. In this context, consumers can be classified into 2 major types- Travelers and Tourists. Travelers are those with the purpose of travelling to these destinations while Tourists can be defined as individuals with the intent to participate solely in leisure activities. Travelers have high susceptibility to substitute shipping travel for time saving flights. On the contrary, tourists are prone to substitutes due to the leisure and onboard entertainment offered by the ferry industry. These collective forces result in a relatively unsaturated market and low rivalry among competitors. High fixed costs, medium level buyers switching costs, relatively low diversity in service results in an industry of high potential growth and expansion.

Figure 1. Substitute Travel

	Tallinn to Stockholm		
Ferry	Duration	Price (Euros)	Availability per week
Tallink	16 hours	80	6
Sijal	16 hours	90	5
Flight			
Balitic Air	1.5 hours	110.29	5
Ryannair	1.5 hours	104.25	4
Finnair	1.5 hours	117.89	4

Figure 2. Industry Analysis

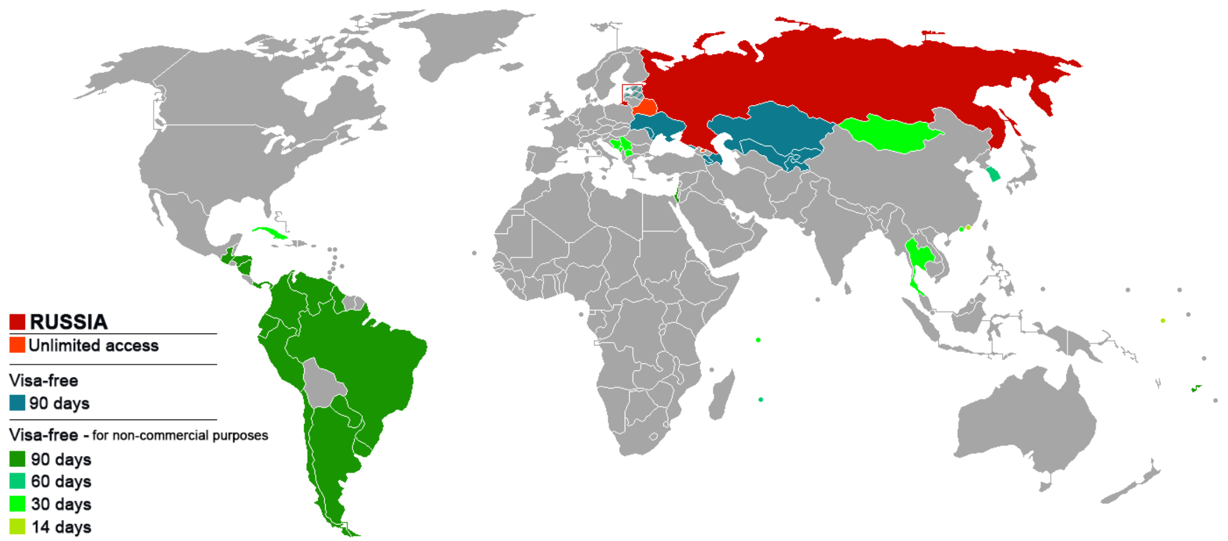


Russian Market

An Attractive market in this industry is located in Russia. As one of the most widely visited countries and currently underutilized, routes to this market can present potential for substantial growth. Attracted by St Petersburg and Moscow’s classical architecture, historical buildings and landmarks, Tourism has an opportunity to flourish in Russia. To conduct a full analysis, Russia’s visa policy in addition to the political, economic and future business environment will be addressed.

Russia allows comparatively low freedom of entrance and a restrictive visa policy than those of other European nations. Greater access is given to citizens of nations within the Commonwealth of Independent States or bilateral agreements, granting visa exemptions as per Figure 3. Despite former citizens of the Soviet Union in Estonia and Lativa granted visa exemptions, the vast majority of Tallink will be faced with the administrative process and an average fee of 30 Euros for this application. Unlike internal EU travel, all items bought within the Ferry must be declared and all items are documented.

Figure 3. Russia’s Visa Policy



Russia’s political climate over the past few years have shown greater improvement for Foreign Investment and trading partnership opportunities. Recently joining the Euro-Atlantic Partnership Council and the Nato-Russia Council, these memberships seek to enhance the security between Russia and Western countries. In the context of business, this means less volatility and an improving environment for long term investment. Interest Rates have shown a decline 1% year over year and is currently lower than most EU at 1.8%. For a Tallink, this translates to cheaper financing options for routes in St. Petersburg. While recently elected president Vladmir Putin stated that “joining the EU would not be in the interests of Russia or the EU”, his policies have so far been instrumental in EU-Russia relations. As a result, the prospects of Russia’s Business climate are favorable. Lower interest rates and tax reduction on foreign businesses have contributed to the optimistic outlook.

Figure 4. Russian Interest Rate

Figure 5. Corporate Tax Rate in Russia

Route Decision (MS Fantasia)

Tallink's decision in purchasing MS Romantika's sistership and establishing routes to Helinski and St Petersburg have been analyzed in Figure 6. Given ticket sales of 150,000 to 250,000, low to high scenarios have been considered. At onboarding sales of $8 per consumer and 2000 cargo units sold, Annual sales would cover fixed investment with a margin of safety of 1.9, 6.1 and 10.2 million Euros respectively.

Figure 6. Fixed Investment Coverage MS Fantasia

Revenue								
			Low (150k)		**Medium (200k)**		**High (250k)**	
	Price							
Ticket	€	75	€	11,250,000	€	15,000,000	€	18,750,000
Cargo	€	250	€	500,000	€	500,000	€	500,000
On Board Sales	€	8	€	1,200,000	€	1,600,000	€	2,000,000
			€	12,950,000	€	17,100,000	€	21,250,000
Costs (Fixed)								
Refit			€	2,000,000	€	2,000,000	€	2,000,000
Advertising & Office in St. P			€	3,000,000	€	3,000,000	€	3,000,000
Flat first year Staff			€	6,000,000	€	6,000,000	€	6,000,000
Total if Loss			€	11,000,000	€	11,000,000	€	11,000,000
Fixed Coverage Profit (Loss)			€	1,950,000	€	6,100,000	€	10,250,000

Investment Analysis (MS Romantika sistership to Stockholm)

The investment analysis of MS Romantika's sistership can be seen in Figure 7 (In Appendix- NPV Analysis). With annual ticket sales at 300,000, ticket price constant at $90 and the cost structure set at 25%, 40% 7% for fuel, staffing and other costs respectively, we apply discounted future cash flow at variable projected growth rates. Consequently, we deduct the cost of the ship at 150 million from this figure. Cash flows are considered within a 30 year time frame and onboard consumption is set at 30 Euros per person. Based on various growth rates, we can see that net present value fluctuates. In this model, 23% growth of ticket sales are required to breakeven a positive value for the firm. While this is within the projected 10-30% growth rate forecasted, onboard sales can add further value. In addition, a source of further efficiency opportunity exists in fuel consumption as the longer distance and newer ship investment model can add to improved fuel economy. It is evident based on Figure 8, this route is considerably more profitable than other routes at 23- 27 Euros in Revenue per passenger with the current ships. Driven by higher spending Swedish passengers and Duty free shopping, we expect this to improve with a newer ship with additional offerings, at 25-30 Euros per passenger (11-14%).

Figure 8. Routes Profitability

Routes	Distance (Nautical Miles)	Margin	Revenue/Passenger
Tallinn- Helsinki	160	28%	€12.36
Tallinn- Helsinki	160	26%	€7.08
Tallinn- Stockholm	486	32%	€23.45
Tallinn- Stockholm	486	30%	€27.78
Pladiski-Kpskar	454	25%	€18.89

Recommendation to Management

Based on the analyses above, we believe there are key strategic decisions to be made and recommend a framework in its implementation to maximize value in the medium and long term.

1. Switch MS Fantasia, Melodia and other older ships' routes to Helinski and St. Petersburg
2. Invest in Romantika's sistership for service to Stockholm in 2004
3. Leverage Public-Private Partnership deals with Estonian and Russian Government (Enter Russian Market- St. Petersburg)
4. Improve onboard services, product offerings
5. Adopt a Marketing & Promotional Mix, promote a unified, unique brand of Eastern European heritage and culture tourism service.

Tallink-Stockholm, New Routes

By switching older ferries and catamarans such as MS Fantasia and MS Baitica to Helinski and St. Petersburg in conjunction with the investment in the newer ship servicing Stockholm, we benefit from key characteristics. Comparatively lower fuel efficiency is aided by the shorter distance and savings of fuel costs per ticket for the older ships, while we are able to maximize sales with the longer distance and onboard sales. The product lines of Duty free shopping and onboard must reflect the interests of the high spending Swedish passenger. Restaurants must be reformed to tailor Eastern European cuisine, plays, music and onboard entertainment must be reflective of the heritage and culture that awaits curious tourists. As a result, coupled with a Marketing and Promotional mix consistent with Eastern European heritage, we expect a higher growth (13% based on analysis) of revenues per customer during the voyage.

Figure 9. Ship comparison High speed vs. Cruise Fuel Economy

Ship Name	Age (Yrs)	High speed vs. Cruise	Capacity	Distance (km)	Fuel Costs	Fuel per km	Consumption per km/pp
Romantika	1	Cruise	2500	160	€ 4,700,000	€ 29,375	€ 11.75
Melodia	23	Cruise	1600	160	€ 13,320,000	€ 83,250	€ 52.03
AutoExpress	**6**	**High Speed**	**575**	**160**	**€ 7,320,000**	**€ 45,750**	**€ 79.57**
AutoExpress 2	**5**	**High Speed**	**700**	**160**	**€ 8,200,000**	**€ 51,250**	**€ 73.21**
Regina Baltica	22	Cruise	1500	900	€ 3,981,250	€ 4,424	€ 2.95
Fantasia	23	Cruise	1700	900	€ 5,530,000	€ 6,144	€ 3.61
Vana-Tallinn	28	Cruise	1500	840	€ 3,020,000	€ 3,595	€ 2.40

Onboard offerings

Onboard offerings must be redesigned to fit the brand of the Marketing and promotional mix of Eastern European culture. While it must be tailored to the Swedish, Finnish and Estonian taste and blend, it is critical to offer a unique Eastern European flavor. This entails serving Eastern European and Scandinavian cuisine, Eastern European Art or adding a mini Estonian Museum. MS Romantika and the newly built ship must create an adventurous, entertaining, seasonally creative environment.

Public & Institutional Partnerships

Partnerships with Government and public institutions can prove effective in this current business environment. There are 2 areas where public or institutional partnership can be effective; 1- solving the visa issue and attracting more tourism into Russia 2- Leveraging national partnerships for subsidies, creating “national or cultural brand”

The current process of $30 a visa for non CIS membership countries, administration fees and difficulty of entrance has a negative impact on tourism. Not only does it deter further travel and value added in the Russian Economy but presents less onboard revenue from a resource based perspective for Tallink. As a result, working with the Russian Foreign policy minister and BSFRF Agency, (Border Service of the Federal Security Service of the Russian Federation) Tallink must negotiate and solution a more attractive process for the consumers. These can be done through various strategic pitches. Leveraging the capital flow of 250,000 consumers a year, or in partnership with the Estonian government, an attractive case can be made. The Ideal terms would be the abolishment of a visa requirement. However, lesser degrees of entrance policy can be greatly beneficial to Tallink and both the economies of Russia and Estonia. This may include a streamlined checking policy similar to when athletes cross borders – limited paperwork, simple, standardized checking process and fluid visa renewals at lower cost for high volume travelers.

Tallink is positioned to use its economic leverage to partner with the Estonian government to pursue long term domestic monopoly (in Estonia) and dominance in Eastern Europe. In the case of Air Canada in its shakeout stage in 1970’s, (owned partially by the government) the government of Canada ensured dominance through restrictions on their competition CP Air. Limiting capacity for cargo carriers and competition, investing in Air Canada’s infrastructure and deregulating the Airline industry, this period proved successful when remaining shares were privatized. Tallink must utilize its emergence in the Shipping Industry not only in this context of spurring deregulation, investment and partnership with the government, but also through its Marketing and Sales mix. While the Estonian government does not have a stake in Tallink, Tallink must utilize its established business model and its economic added value in Estonia to negotiate deals for long term growth. These include:

Type	**Parties Involved**	**Benefit & Reasoning**	**Alignment of Interest**
Tax Credits for Capital Expenditures	Estonian Government, Tallink	Refresh of Capital are vital, additional cash flows are required for reinvestment in enhancing offerings onboard, leading to longer term growth	Estonian Government's interest to Export Estonian Tourism, attract Investmnet. Tallink's interest is
Visa Subsidies for Russian Market	Finnish, Estonian, Swedish Governments	If Visa requirement still required, to attract growth in Tourism, spur investment and spending.	Growth of Tourism Industry increases spending & liquidity at macro level & additional consumer spending – benefit to all parties
Additional Employee benefits by the government	Estonian Government, Tallink	To maintain medium & high skilled workers. Tourism industry have high Employee Turnover	Increases less Tourism Labour Turnover & costs associated. Labour efficiency & productivity, increase in GDP.
Sales & Marketing investment, state owned Media coverage	Estonian Government, Tallink	Adopt National Brand, create monopoly and dominance	Tallink-Monopolize the Market. Estonian Government-Support Domestic Companies vs. Foreign

			companies causing capital outflow

Industry Outlook & Risk Factors

Driven by improving macroeconomic climate in Europe, trade membership and consolidation of EU membership, we forecast an improvement in the Shipping and Ferry Industry at a rate of 6-10%, similar to consumer discretionary growth. A key driver is Russia's foreign and Visa policies. Commanding 20% of Europe's population with the largest growth potential and Eastern Europe's Tourism capital, its visa policies, relationship with major powers will influence the flow of movement. Embargos and barriers will hurt movement of capital and investment in Russia. However, we forecast additional barriers to be torn and Russia to join the EU by 2010. With new leadership, Russia has shown better Foreign Direct Investment potential and a favorable environment for Tallink to establish business in St. Petersburg. We believe this new initiative of greater investment in Russia to drive down corporate tax rates to 15%, on par with major Western Economies and interest rates to dive to 10% within the next decade. We also forecast major players in this industry will merge, gaining additional leverage in buying power from suppliers and improving efficiency and productivity. With better technological advancements we believe ship building will benefit from lower costs of raw material extraction and processes, further aiding this industry.

Some of the headwinds we believe lies for this industry are the rising labor costs. While we believe there will be some opportunities for Automation and productivity (lower skilled tourism related jobs- service, catering, etc) rising costs we believe will be at a rate of 5-7%, similar to income growth. Labor Unions and regulation may add additional costs to the cost structure and limit the bottom line. Furthermore, political and social impacts will impact consumer sentiment and may limit travel. These include terrorism, economy sentiment (savings rate) and political candidates.

Conclusion

In this report, we have reviewed a comprehensive analysis of Tallink's business case- its business model, industry, macroeconomic and political climate through the lens of international business. We believe Tallink is uniquely positioned to grow and maximize long term value. We have laid out the strategy for its implementation through reengineering its product line while seizing institutional partnerships and entering the Russian Market. In doing so, we have also forecasted the industry outlook including the risks and roadblocks in this industry along the way ranging from macro factors to specific hurdles while entering the Russian Market. In conclusion, Tallink must consider diverse factors in an ever-changing market to implement this strategy while striving for cost and operational leadership amongst its peers in this industry to capture this opportunity.

Appendix

Figure 7. Investment in Ship NPV Analysis

References

ARKA News Agency. (2014). Russia brings in new travel rules for nationals of visa-free countries, including Armenia. *ARKA News*, 4-10.

Åslund, A. (2008). *An Assessment of Putin's Economic Policy.* London: Peterson Institute for international Economics.

European Commission Directorate-General for Economic and Financial Affairs. (2000). *European Economy.* Brussels: European Commission.

KLM Royal Dutch Airlines. (2016). *Visa Information, Russian Fed.* Amsterdam: KLM.

Liza, Tripsget. (2010, 10 5). *Tripsget*. Retrieved from #TRAVELTIPS – RUSSIAN VISA: HOW TO VISIT RUSSIA VISA-FREE ?: http://tripsget.com/blog/2016/02/traveltips-visa-to-russia-how-to-visit-russia-visa-free/

OECD. (2016). *Household Spending- Historical.* Chicago: Organization for Economic Co-opation and Development.

Sue, J. &. (2011). Choosing When To Travel: High, Low And Shoulder Season In Europe. *The Savy Backpacker*, 3-5.

Trading Economics. (2016). *European Union GDP Annual Growth Rate.* New York: Trading Economics Ltd.

Case

Ivey, Richard Ivey School of Business. University of Western Ontario. 2009-9-30: *Tallink: Connecting Estonia to Finland, Sweden and Russia*