A MAGAZINE FOR AIRLINE EXECUTIVES 2005 Issue No. 2

ascend

Taking your airline to new heights

THE TRANSFORMER

A conversation with …

W. Douglas Parker, Chairman, President and CEO, US Airways

page 44

INSIDE

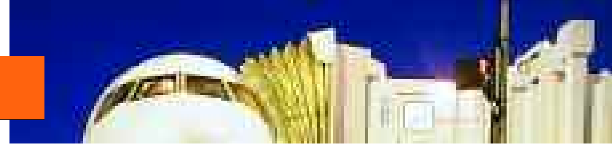
33 Gulf Air's in-flight service wins top awards

36 SAS restructures to better compete

42 Jet Airways becomes an international carrier

© 2009 Sabre Inc. All rights reserved.

wearelistening@sabre.com



Crossing the Border

True global consolidation of the airline industry is hindered by current governmental policies that limit cross-border ownership, but pressure to change such regulations could lead to an industry transformation.

By Shane Batt | *Ascend* Contributor

The airline industry has been reverberating with calls to ease cross-border ownership restrictions for the past 12 to 24 months, primarily centered on the issues of investment in U.S.-based airlines. United Airlines as well as American Airlines and Delta Air Lines have called to raise the foreign ownership limit of U.S. carriers from a maximum of 25 percent to the European Union level of 49.9 percent. In fact, legislation, currently under review by U.S. legislators, is designed to raise this restriction to E.U. levels.

The primary question facing the industry is, "How will the industry change if and when cross-border ownership restrictions are reduced or eliminated?" This issue is of strategic importance to an industry that is rapidly maturing while it is struggling financially.

Basic Economics

When considering how the airline industry will be impacted by greater flexibility for cross-border equity investment, it is important to consider the results of other industries when similar restrictions have been eliminated. There have been several notable examples of cross-border ownership restrictions being reduced. Perhaps the best known example, however, has been seen in the automotive industry. Germany's Daimler-Benz purchased a substantial interest in Chrysler Corp. of the United States; Ford Motor Co. of the United States purchased a controlling interest in both Jaguar and Aston Martin of the United Kingdom and Volvo of Sweden; and Germany's Volkswagen purchased Bentley Motor Company of the United Kingdom in recent years. Also, recently, Shanghai Automotive Industry Corp. announced its intention to purchase the defunct English automobile manufacturer, Rover. These represent only a few examples of cross-border ownership changes that have occurred and continue to occur within the automotive industry. The interesting point regarding cross-border investment in the automotive industry is that it has remained almost entirely within the industry — automobile companies have been purchasing automobile companies: the process of consolidation. In fact, all popular examples where cross-border ownership restrictions have been eased have resulted in consolidation, which has been happening in several industries, including banking, oil and gas, pharmaceuticals, hotels, and essentially in every industry where restrictions have been removed.

Some economists claim that consolidation is an inevitable result of the maturity of an industry. They would call consolidation "basic economics" — as goods and services move from luxuries to commodities, consolidation is one of the basic economic patterns that emerge.

When automobiles were first produced, they were definitely luxuries. Luxury brands were founded early in the evolution of that industry, and as automobiles moved from luxuries to commodities, consolidation of the industry increased. The results have produced economies of scale for automobile manufacturers and allowed for higher profits while unit prices for cars have remained low. In fact, one

DaimlerChrysler, a truly global company

Global consolidation has already begun to take root in various businesses, including the automotive industry. Companies such as DaimlerChrysler, owned by European, U.S. and other international investors, has benefited from the ability to attract capital from around the world. The ¤142 billion (US$192.3 billion) company provides an example of the benefits that could be achieved by the airline industry if cross-border ownership restrictions are eased or eliminated.

2005 DaimlerChrysler launches the Crossfire Roadster, a colborative effort between United States and European groups.

Copyright © 2005 DaimlerChrysler Corporation.

Photo courtesy of DaimlerChrysler

Sabre Airline Solutions' archives

Airline executives are beginning to build stronger relationships with their peers around the world to develop relationships that may prove beneficial if ownership restrictions ease. While some regulators argue that airline consolidation reduces competition, the industry's financial indicators suggest otherwise. Some carriers, such as Cathay Pacific Airways with its interest in Air China, offset the affects of low margins and increase share value by linking with other companies.

measure of the maturity of the industry is related to how much consolidation has occurred.

Consolidation in the Airline Industry

Consolidation in the airline industry is not a new occurrence, but one that has been accelerating in recent years. Almost every region of the world is seeing some degree of consolidation within the industry. For example, America West is merging with US Airways in the United States (see related article on page 44). Recently, OceanAir in Brazil purchased a controlling interest in Colombia's Avianca. Europe's Air France merged with KLM, and a union between Lufthansa and Swiss International Air Lines has recently been approved. Even the Far East is seeing its share of consolidation with Cathay Pacific Airways taking an interest in Air China while both companies have an interest in Dragonair.

This type of consolidation is not limited to traditional network carriers. Even low-cost carriers are consolidating. Europe-based easyJet purchased Go, the former low-cost subsidiary of British Airways; and Ryanair purchased Buzz, the former subsidiary of KLM. In recent months, JetStar Asia announced its merger with Valuair to form the new Orange Star group of airlines. These are all recent examples of consolidation; however, it's gone on throughout the history of the industry.

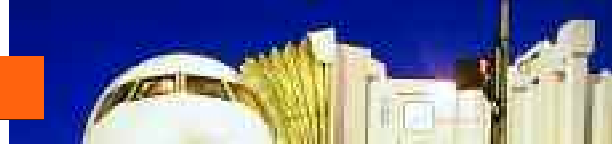
One important characteristic of consolidation in the airline industry has been the substantial amount of regulatory oversight that has accompanied this process. Because there seems to be a belief among many regulators that the primary purpose of consolidation within the industry is to remove competition from the marketplace, many potential mergers and acquisitions have been blocked or died under regulatory scrutiny.

While it is possible that some airlines considered investing in others to reduce competition, the financial indicators in the industry do not bear this out. Yields have steadily decreased in the industry since the beginning of deregulation in the late 1970s. In fact, yields have decreased at an alarming rate in real terms even though industry costs have increased, causing the margins in the industry to remain low overall and, as a result, leading some carriers toward consolidation.

The primary driver of consolidation of the industry relates to increasing the share value of constituent companies. Share value in the airline industry is not driven by dividends since it is very rare for most airlines to issue them. Therefore, since investors do not receive an income from their airline holdings, they expect to receive value based on the growth in share value, which is directly related to both the increase in assets of airlines as well as their delivery of reasonable levels of profitability (typically a 3 percent to 8 percent net margin). Therefore, the requirement to increase their share value drives carriers to examine consolidation as a way to increase assets as well as deliver the all-important economies of scale that allow for profits to be maintained in the face of rapidly rising costs. Consolidation is a process that continues to accelerate in the industry despite the restrictions on foreign ownership that impact the availability of capital in many regions.

History is to Blame

Airline owners often bemoan that regulators put unfair restrictions on the airline industry in several forms including taxation, safety and security requirements, and similar regulatory oversight. It is important, therefore, in consideration of cross-border ownership restrictions to examine why governments



U.S. majors United Airlines, American Airlines and Delta Air Lines have all called for U.S. legislators to raise the foreign ownership limit of U.S. carriers from a maximum of 25 percent to the European Union level of 49.9 percent, which will increase opportunities for cross-border ownership in the airline industry.

Photos courtesy of United, American and Delta

may be reticent to ease these rules. In the past, most governments considered domestic airlines as part of their strategic and tactical defense mechanisms. It is still prevalent in many countries for civil aviation authorities to be under the control of the military. Governments considered airlines important for three primary reasons:

- An airline's impact on the economic health of the country,
- An airline's availability for transport of critical military personnel and materiel,
- The possibility that an airline's equipment could be used for military purposes.

For example, during the 1980s, the U.S. government introduced the "Kraft Program" under which airlines received aircraft upgrades and the free installation of cargo doors in exchange for the right of the government to use the aircraft during times of war. Many of the country's airlines considered the possibility of a conventional war fairly remote in the late 1980s and agreed to the Kraft Program with the belief that the equipment upgrades were essentially "free money."

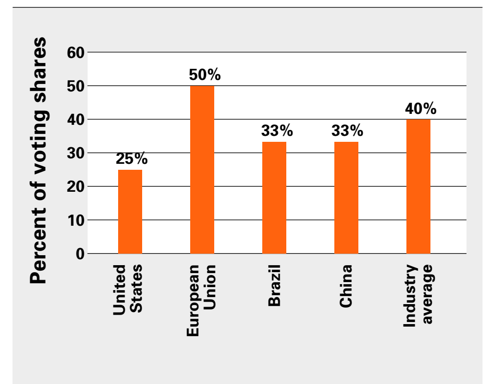
At the outbreak of the first Gulf War, however, the carriers' aircraft were pressed into military service for carrying materiel and personnel into the Middle East, creating a substantial history for the strategic and tactical importance of the airline industry to the defense initiatives of countries. Since many countries see their defense capabilities intimately tied to their domestic-based airlines, their governments have been reluctant to release ownership restrictions, which is not entirely unique to the airline industry.

Recently, regulators in the United States injected substantial barriers into the bid for Unocal, the California-based oil company, by CNOOC, the Hong Kong-based, but Chinese controlled, oil giant. In this case, the regulators questioned whether it was in the strategic interests of the United States to allow Chinese control over such an important commodity as oil. To paraphrase United Kingdom Prime Minister Tony Blair, "there is more smoke than fire" involved in this particular debate. The Unocal/CNOOC issue, however, clearly demonstrates that governments feel that it is their responsibility to protect strategic and tactical industries that have a defense impact.

Why Lift Ownership Restrictions?

Since governments appear to have a predisposition to maintain restrictions on ownership in the airline industry, what would induce them to ease or lift these restrictions? The primary reason ownership restrictions would be eased ties directly to the availability of capital for investment in the industry. Today, a substantial imbalance in ownership restrictions in different venues exists. In the United States, foreign ownership is restricted to 25 percent of an airline's total shares. In the European Union, however, the foreign ownership restriction is 50 percent minus one share. Furthermore, ownership of airlines by other companies within the European Union is basically unrestricted (except for issues related to anti-trust). In Latin America, where consolidation of the airline industry is the most advanced, restrictions vary from country to country, but regulators take a very pragmatic view to these restrictions. For example, Oceanair, through its holding company Synergy Group, a Brazilian-owned company, purchased 75 percent of Avianca de Colombia in a deal that was positively courted by Colombian regulators. Most sovereign entities

Foreign Ownerhip Restrictions for Airlines



Various foreign ownership restrictions around the world impact the flow of capital, making it difficult for the airline industry to enjoy the benefits of other industries that have experienced cross-border consolidation.

have either settled or are moving toward the European Union model of 50 percent minus one share. These varying ownership restrictions, however, impact the flow of capital in the different autonomous venues.

The aviation industry continues to attract capital on a worldwide basis despite the financial difficulties experienced by the industry. Low-cost carriers continue to be the "darlings" of the aviation investment community due to their high profits and growth, which result in their high share-value growth. However, even traditional carriers are attracting capital in many venues. There have been a series of initial public offerings in the industry in the past 12 months, most of which have been in regions outside of the United States. In each case, the IPOs in the industry have been over-subscribed, where there has been more capital available than required and owners have been able to pick and choose which capital they want. The one location, however, that has been bleeding capital for some time is the United States. The country's carriers have lost billions of dollars in share value since 2001, and they continue to struggle to find new sources of equity. When there is a strong availability of capital for the airline industry in non-U.S. countries and a distinct shortage of capital in the United States, there is a strong pressure on regulators to ease ownership restrictions. Momentum is building for eased restrictions in the United States, and other venues are expected to quickly follow.

Brave new World

Assuming that cross-border ownership restrictions are eased, changes will be seen in three primary areas within the airline industry:

1. Consolidation in the industry will accelerate.
2. Global Alliances will increasingly be based on equity investment.
3. Regulatory oversight will increase around landing rights and airport slots.

While these changes are significant and will affect stakeholders, including passengers, airline owners and airline employees, it is unlikely that these changes will produce upheaval within the industry.

There is little doubt that easing the restrictions on cross-border ownership will accelerate the process of consolidation within the airline industry. Because regulatory authorities are often concerned about anti-trust impact, consolidation of carriers within a particular country is often blocked. For example, it is nearly impossible to fathom American Airlines buying troubled United Airlines — even if American had the available capital — because the combined carrier's domestic dominance would constitute a monopoly on many routes. The "easy" consolidations have mostly occurred throughout the industry. Meanwhile, increased foreign ownership often produces less issues of an anti-trust nature. Therefore, it is likely that the easing of cross-border ownership restrictions will further boost the process of international consolidation. Nonetheless, this is not a panacea for troubled carriers, particularly in the United States. Airlines will have to address the fundamental issues affecting their profitability. Labor costs, overhead costs and maintenance expenses are just three of the infrastructure-related areas where U.S. carriers need to make substantial savings before they become attractive to foreign investment. U.S. carriers have lost a lot of their attractiveness for the U.S. capital market. Suddenly making foreign capital available will not automatically make these airlines more attractive. First, these airlines will need to successfully finish their restructuring efforts.

HIGHlight

Despite the recent trend toward "open-skies" agreements, when particular multi-national corporations own substantial rights in multiple venues, regulators are going to become increasingly concerned with the ability of all market players to compete.

Global alliances will play a substantial role in increasing this consolidation through direct equity investment among partners in the alliance. To a great extent, the global alliances exist to allow a partial "commercial consolidation" of the industry that is blocked by current foreign ownership restrictions. Global alliances are not allowed to take many commercial actions, such as setting common prices that would be allowed if global alliances evolved into single-company "super carriers." Global alliances have produced recognizable global brands with common product quality, common sales and distribution practices as well as common operational approaches. Therefore, the process of integration is already partially completed within global alliances. So, global alliances are likely to stimulate a substantial amount of equity investment among their members in the event that cross-border ownership restrictions are eased. Additionally, the appeal of global alliances will increase for all stakeholders — passengers, member airlines and potential investors — producing a resurgence in interest among potential new members.

To date, the affects of easing cross-border ownership restrictions appear to be mostly positive for the airline industry. This will not be entirely the case, however. It is likely that regulatory oversight and restrictions on landing rights and airport slots will increase as cross-border restrictions on ownership are eased. For example, when LAN, the Chilean-based airline formerly called LanChile, requested landing rights in Miami, Florida, for its new subsidiary, LanEcuador, U.S. regulators initially declined the application by stating that LAN's purchase of LanEcuador was simply a ruse to bypass landing-right limitations in the bilateral agreement between Chile and the United States. LanEcuador was not, in fact, granted landing rights until LAN diluted its ownership of the affiliated airline to 45 percent. These aggressive moves by regulators are liable to increase as cross-border ownership restrictions ease.

Despite the recent trend toward "open-skies" agreements, when particular multi-national corporations own substantial rights in multiple venues, regulators are going to become increasingly concerned with the ability of all market players to compete. Therefore, regulatory restrictions related to landing rights and even airport slots are liable to increase as ownership restrictions reduce.

While there may be a substantial long-term impact on the structure of the industry should the cross-border ownership restrictions be eased, it is doubtful that these changes will produce turmoil or upheaval. The changes to cross-border ownership will likely lead to an international stability in the industry but not a dramatic paradigm shift. Struggling carriers will not automatically turn healthy with the introduction of foreign capital. Instead, these companies will have to correct their structural issues to be attractive to foreign investors who have substantial money to invest in the industry. The availability of foreign capital will alarm some citizens just as globalization continues to produce its opponents.

Despite the emotional rhetoric that is likely to occur, the easing of cross-border ownership restrictions in the airline industry should produce a healthier industry that offers better returns for its shareholders and more stability for its stakeholders.

Shane Batt is a senior partner with Sabre Airline Solutions Consulting. He can be contacted at shane.batt@sabre.com.