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A Conversation with
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Recipe for a Merger

Despite the many obstacles accompanying airline mergers and acquisitions, carriers that rise up to the challenge often remain the industry's top players.

■ By Peter Berdy | *Ascend* Contributor

The appetite for mergers and acquisitions seems insatiable in the airline industry. Companies link up in different ways imaginable, from joint ventures and cross-financing to friendly acquisitions and hostile takeovers. Whether airlines are in poor financial shape or good condition, the lure to acquire seems irresistible.

Yet mergers and acquisitions have a mixed track record. They are highly visible in the

media and expensive to consume. They divert attention away from running the core business, and they don't always work. They are newsworthy because of the association with corporate and personal survival, the potential drama surrounding layoffs, and the closures that often accompany acquisitions ... not to mention the possible loss of identity of a known brand.

On the other hand, there have been showcase examples of success in the air-

line industry, such as Air France/KLM and US Airways/America West.

Across all industries, more than 75 percent of mergers do not produce intended benefits, according to Booz Allen Hamilton's 2002 "Airline Merger Integration: Take-Off Checklist." Common reasons for failure include a collision of management styles, complexity of tasks to make a merger work and differences between corporate cultures.

Selected Merger and Acquisition Examples

| Concept | Owner | Target or example | Notes |
|------------------------|------------------------|------------------------------------|---|
| Full merger | Lufthansa | Swiss | 100% ownership, retain Swiss brand |
| Partial acquisition | SAS | Spanair, bmi, Air Greenland | Partial Ownership: 95% Spanair, 20%-bmi; 37.5%-Air Greenland |
| Mixed ownership | Cathay Pacific Airways | DragonAir | Ownership: 100% DragonAir, 17% Air China. Potential 3-way among Cathay, Air China and DragonAir |
| Hostile takeover | AirTran Airways | Midwest Airlines | |
| Cross-border expansion | LAN | LAN Argentina, LAN Peru, New Varig | Provide financing to acquire shares or set-up airline in non-home country |
| Private equity | Texas Pacific Group | Ryanair, Iberia | Private equity firm investing in different airlines |
| Joint venture | Virgin | Air Jamaica | Transfer LHR slots, operate Jamaica UK as a codeshare |
| Global play | Air One | Alitalia | Restructure and expand flag airline |

Several merger and acquisition opportunities, ranging from full and partial ownership to joint ventures and hostile takeovers, have airlines around the world taking risks to secure their future.



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The key to a successful merger is to take the top attributes of each airline and merge into a single large, healthy operation. The teaming up of US Airways and America West combines the best aspects of a low-cost carrier and a full-service airline.

“What’s good for investors, shareholders and management may not be good for others,” said analyst Kevin Mitchell of the Business Travel Coalition. “Lots of employees will be laid off, and customers can look forward to 20 percent to 30 percent price hikes and several years of customer-service misery.”

But according to US Airways Chief Executive Officer Doug Parker, you can take the best of each company and merge into one, large, healthy, successful operation.

“US Airways is the product of several successful mergers, most recently the combination of America West and US Airways,” Parker said. “Working together, we have blended employees and cultures to create a new standard in the industry, which combines the best attributes of a low-fare carrier and a full-service airline.”

And the story was much the same for Air France and KLM. When the two carriers merged in 2004, they took a similar approach and utilized the strengths of both companies to build a thriving airline.

“The new entity has the potential to develop powerful synergies,” Air France/KLM Chairman and CEO Jean-Cyril Spinetta said at the time of the merger. “The complementary nature of the two airlines, which will each retain their brands and unique values, will ensure that the new group is more attractive for passengers,

as they will gain access to an enhanced offering and create substantial shareholder value.”

Why Join Forces?

The most powerful reason for a merger or an acquisition is to create shareholder value. This may be accomplished in several ways, including:

- Offering an immediate financial premium: Providing existing shareholders in the company to be acquired a premium as a financial incentive to do a deal.
- Leveraging economies of scale: Reducing costs by eliminating duplicate departments or operations.
- Increasing market share: Combining to generate greater overall revenue than each company could generate on its own.
- Cross selling: Acquiring and selling complementary products and services to boost revenues.
- Exploiting synergies: Making better use of both airlines’ resources to lower costs and boost revenues — an acquisition can uncover value that should exist through scale, such as increased network connectivity, improved aircraft utilization, expanded market coverage, combined frequent flyer programs and increased purchasing power.

- Leveraging tax opportunities: Using the target airline’s tax write offs to improve the bottom line.
- Business diversification: Expanding to related businesses (maintenance, repair and overhaul; cargo businesses; travel agencies) as a hedge against changing market conditions.
- Geographical diversification: Circumventing regulatory hurdles by purchasing a company already in business in a new geographic area, which also gives airlines the ability to compete more effectively on a global basis.
- Transferring resources: Redistributing and combining scarce resources such as slots, airplanes and technology.
- Selling undervalued assets: Releasing value by spinning off business units, which can also be used to pay for acquisition of other businesses.
- Vertical integration: Acquiring part of a supply chain and benefiting from joint resources and lowering costs.

Additional potential benefits for airlines include:

- Strengthening the home market and attracting the business-customer segment,
- Providing a network that offers multiple routing choices to expand network coverage and time-of-day choices as well as more connections to customers,

- Reducing overlapping flights,
- Integrating frequent flyer programs to offer customers more ways to earn and redeem miles,
- Expanding alliance membership,
- Improving the fleet through simplification and modernization,
- Reducing costs by integrating airport operations and lowering costs of procurement and financing.

Challenges

Regardless of the size of the carrier, its business model or route network, there are always challenges that must be successfully addressed to make a merger or acquisition work well. The most common obstacles airlines face when merging or acquiring another carrier include:

- Inadequate due diligence of the target business, resulting in a lack of understanding the true state of the company about to be acquired. This may lead to overpaying for the company and misjudging financial performance capabilities once the company is acquired.
- Losing focus on running the core business during the process of the acquisition or merger. The process can be lengthy and intense, requiring full-time attention and executive management participation. During this time, executives can easily lose focus of their main priority — running the day-to-day business.
- Underestimating labor complexities that arise from negotiating changes to union work rules, existing labor laws and the difficulties of integrating workforces. The risks range from the potential for labor disruptions to paying a steep price for labor peace. There are often imbalances in pay and work rules that need to be dealt with as well as the need to create harmony across different companies that may share the same unions.
- Financial considerations, such as how deep the pockets need to be to pay for integration and cover unanticipated costs. There is the potential of a financial shortfall related to overestimating the value of synergies and achieving the actual financial performance that was projected in the business plan as well as pressures coming from competitors trying to take advantage during the transition period. There's also unit revenue pressure with the expectation that the combined entity should have greater capability to increase fares or control inventory.
- Technology issues ranging from inheriting legacy systems, in- and out-sourced functions, and mismatches in capability and delivery. Technology touches all aspects of the airline's business as well as the customer experience. Improper integration and cutover of systems have serious adverse affects on operations and customer satisfaction.



The combined America West and US Airways operate under a single brand offering everyday, simple low fares to more than 225 destinations around the world.

- Gaps between targets set in the business plan and actual performance once the acquisition takes place. The plan needs to be stress tested to consider the affects of poaching by competitors (such as entering markets, running fare sales or offering jobs to key personnel) as well as a potential migration of loyal customers who are sometimes forgotten along the way. These sensitivity tests are important to evaluate the potential downside if key assumptions fail to materialize.
 - Cultural challenges. Differences between corporate cultures, political challenges and language barriers are hurdles that need to be overcome. The company could be a poor business fit if these are not addressed upfront.
 - Management's capability to deliver. Mergers and acquisitions spur management to develop overambitious visions and plans that could lead to failure to deliver bottom-line results. Executives who have never been through a merger or acquisition find they may have underestimated the resources, talent and time required to successfully complete a deal.
- While an acquisition may look easy on paper, the trick is how to actually integrate operations successfully and to really achieve lower costs while avoiding service disruptions and even improving operational performance. Decisions can easily become politicized over items such as who flies in certain markets, which employees stay or go, and who pays for different costs that are incurred during the transition.

With all the challenges inherent in mergers and acquisitions, there is also a list of best practices to address certain issues:

- Perform adequate due diligence; understand the financial state of affairs of the company to be acquired, learn how the airline currently runs its business, and identify the leaders and potential detractors.
- Start well before the deal is closed, and allow sufficient time to achieve integration of the acquired airline.
- Assess the fit of the airline to be acquired, and determine if this company provides real benefits (expanding services to customers, providing market coverage to broaden the base of customers and enabling economies of scale) and offers real efficiencies for the combined entity.
- After developing the strategic vision of the combined entity, airline executives should move to tactical steps on the transaction structure and integration plan. They should identify how the structure will take place and prepare a realistic timetable for the acquisition.
- Appoint a leadership team that's sole job is to work on the acquisition and implement the business plan. In addition, determine who will manage professionals, such as bankers, consultants and attorneys, during the acquisition process who are needed for the transaction. Determine how to use these external resources efficiently and effectively, and have them commit to timelines and deliverables.
- The leadership team must develop a detailed integration plan with key activities and work

tasks to be completed. It needs to describe how they will get the job done, who is responsible for which tasks and when those tasks are to be completed. The leadership team should also identify critical success factors, determine how to measure performance, build a communications plan and create reporting structures.

- Specify how processes and functions will be integrated and what systems and resources will be needed. Set priorities, with the intent of realizing expected benefits quickly. Areas likely to produce early financial results include procurement, pricing, revenue management, sales and distribution. These should be followed by benefits derived from network and schedule changes and operations consolidation.
- Review ways to reduce complexity and simplify operations. This includes harmonizing fleet through a reduction of airplane types, reducing the number of suppliers and parts, and identifying specific synergies that should provide cost savings, including consolidating overhead and sharing facilities such as airport counters and gates.
- Measure and evaluate synergies realized by the merger or acquisition and compare the actual performance to the plan.
- Establish controls and processes to resolve problems that may arise from the acquisition, especially in operations, to avoid crippling interruptions or staff defections.
- Communication must be consistent and frequent to deliver management's goals, objectives and timetable for specific targeted audiences. A communication plan should include different employee groups at both airlines as well as separate communication plans for investors, airports, government and regulatory agencies, suppliers and partners, and the press.
- Address existing relationships with partners, vendors and suppliers in terms of communicating the transaction, and identify what they should expect from you and you from them. Be sure critical suppliers are paid on time, and identify how to address past liabilities the acquired company may have.
- Look at the customer's point of view and see how to make customers benefit from the onset. To retain and expand business with existing and acquired customers, consider using promotions, special events, fare sales, frequent flyer program bonuses and similar activities linked to the acquisition.
- Address labor concerns early on to avoid resource issues. Identify and communicate the overall plan, specifically what is expected of each of the labor groups. Answer questions concerning critical labor items such as if there will be job cuts, work rule changes, trade offs and other issues that will be of high concern to employees of each airline.

- Understand the cultural and environmental differences of the two companies, and develop a plan to harmonize. Determine how to preserve key elements of employee pride, history and brand value of the acquired company as a transition to a new state of evolution rather than positioning it as a company that has just conquered a competitor to drive them out of business.

would reinforce the need for consolidation. They wanted to take advantage of changes about to take place in the political climate and economic environment that were on the horizon. This included the advent of a single European aviation market, preparation for likely open skies between the European Union and United States, and opportunities resulting from enlargement of the European Union.

HIGHLIGHT

“Regardless of the size of the carrier, its business model or route network, there are always challenges that must be successfully addressed to make a merger or acquisition work well.”

Air France/KLM Success

Air France/KLM announced intentions to merge in 2003 and completed the transaction in 2004. Following the announcement, the carriers followed their plan and have outperformed financial expectations. In 2004, these two major flag airlines combined, creating the largest airline in terms of passenger revenue with a combined turnover of approximately €20 billion (US\$27.4 billion).

What was the rationale for their merger? They recognized that a single E.U. market

They had a clear vision of what to offer customers and shareholders: a solid financial company, providing superior customer service, the willingness of management to extract value from synergies while at the same time preserving their identities, brands and value.

Air France/KLM also saw opportunities in cargo operations as well as in the maintenance, repair and overhaul business. Their combined networks also provided extensive coverage of major global cargo flows to create the largest cargo revenue turnover in the world. They



Photo by shutterstock.com

While KLM and Air France continue to operate under their own brands, their merger three years ago has enabled the combined group to develop powerful synergies and provide a more attractive passenger airline.

viewed expansion as a MRO provider to their existing customer base of other airlines since they had Airbus and Boeing capabilities and had good relationships with original equipment manufacturers.

The companies had complementary networks and foresaw benefits to an enlarged SkyTeam alliance. Previously, KLM was not a full member of SkyTeam. At the time of the merger, the carriers had 101 long-haul destinations, including 31 common destinations, 43 unique destinations for Air France and 27 for KLM. They recognized their hub airports as assets that could be leveraged to propel further

revenue management harmonization; improving fleet utilization, coordinated management. Estimated synergies: €100 million (US\$137 million),

- Cargo: Network optimization, commercial alignment, support services. Estimated synergies: €35 million (US\$48 million),
- Maintenance: In sourcing, procurement, pooling spares and stock; creation of "center of excellence." Estimated synergies: €60 million to €75 million (US\$82 million to US\$103 million),
- Information technology: Convergence of systems. Estimated synergies: €50 million to

would include representation from its partner airline.

The financial transaction provided a premium to KLM shareholders that included benefits from the restructuring plan that was already underway at the time of the merger. It also enabled KLM shareholders to benefit from future synergies and growth opportunities as well as be shareholders in a significantly stronger group. For Air France shareholders, their financial benefit included gains from annual synergies derived in the first year and large potential upside from expected financial synergies in future years.

There was a three-year timetable to enable a smooth transition and allow time to secure regulatory permissions and traffic rights. On the regulatory front, the carriers needed anti-trust clearance from the European Commission, the U.S. Department of Justice and the French Commission des Privatizations et des Transferts.

They indicated creation of greater opportunities for employees and worked with labor groups on harmonization.

Air France/KLM acquisition activities also focused on their customer base. They publicized a larger overall network, linking two systems with schedule enhancements and frequencies between hubs. They enhanced service to home markets with greater frequencies, offered frequent flyer benefits to earn and claim rewards in either program, and provided lounge access in both airlines' networks to eligible customers of either airline. They announced electronic ticketing and offered attractive fares as well as special promotional fares. Through schedule coordination, they offered customers connections via Paris or Amsterdam, which offered more choices of routings and time-of-day travel.

A well-designed airline merger or acquisition can produce superior results, including returns to shareholders and benefits to consumers, despite the complexities of integrating two businesses. There are significant hurdles that need to be overcome to integrate two airlines, and a smooth ride is not assured.

Airlines are a service industry, requiring cooperation of employees who are in direct contact with customers and operate the day-to-day business. An appropriate labor strategy and implementation is essential to secure employee buy in and obtain cooperation to ensure satisfactory operational performance. ■

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HIGHLIGHT

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expansion. At the time of their merger, 75 percent of long-haul flights in Europe were concentrated in 10 European hubs, with four hubs providing more than half those flights (Paris, France; Amsterdam, Netherlands; Frankfurt, Germany; and London, England). Air France's hub in Paris at Charles de Gaulle and KLM's hub in Amsterdam Schiphol are among the E.U.'s largest hubs. The carriers knew their two airports allowed for network expansion while other large hub airports had capacity constraints.

The carriers effectively communicated passenger benefits — such as a larger choice of routes and destinations, more seats at lower fares, and more attractive frequent flyer programs — to the public and their customer bases.

They took advantage of synergies and developed a timetable to achieve them smoothly. A recap of the actions the carriers undertook and estimated annual value of synergies produced by the fifth year is based on a 2003 presentation entitled, "Creating Europe's Leading Airline Group." The airlines worked strategically in several key areas to secure their future together, including:

- Sales: Coordinate sales structures; sales cost improvements; handling and catering. Estimated synergies: €100 million (US\$137 million),
- Network, scheduling and revenue management: Network and schedule optimization;

€70 million (US\$69 million to US\$96 million),

- Procurement: Cost reduction. Estimated synergies: €10 million to €30 million (US\$14 million to US\$41 million).

The carriers estimated 60 percent of total synergies would come from cost savings. Of the total improvement projected for operating earnings, half was to come from internal costs, a quarter from external cost savings, and a quarter from network adjustments and fleet rationalization.

The merger structure and organization covered areas of interest to key stakeholders, and it was to be a publicly listed holding company with two operational airlines. The structure preserved two brands and identities and was designed to operate with simplicity. Both airlines were to maintain their operating licenses, transport certificates and traffic rights. They were to be managed by cooperative governance, with Air France appointing the chairman and CEO and KLM vice chairman of the board and KLM CEO. They used a strategic management committee to govern the implementation, which consisted of an equal number of members of both carriers. The committee was responsible for network and hub coordination, fleet and investment strategy, and alliance and partnership strategy. Each airline would be responsible for its own commercial and operating management, including airworthiness and flight safety, human resources, and product delivery. Corporate governance of each airline