



# THE BARBARIANS ARE STILL AT THE GATES

Some carriers may continue to be targets of private equity firms as pressure for privatization and consolidation of airlines unfolds this year.

By Peter Berdy | *Ascend* Contributor





Private equity has a colorful history, first gaining prominence during the junk-bond and leveraged buy-out heydays in the 1980s. Most notable was the case of RJR Nabisco. In 1988, RJR Nabisco was purchased by private equity firm Kohlberg Kravis Roberts & Co. (now called KKR), in what is the second-largest buy-out in history (the 2007 buy-out of the Texas-based utilities giant, TXU, by KKR, TPG Capital and Goldman Sachs is the largest).

At that time, the use of a leveraged buy-out to acquire RJR Nabisco along with the aggressive pursuit by the private equity principals was seen as an ominous threat to the free capitalist structure. The men behind these plays were termed “corporate raiders” and “barbarians at the gate.” (The story was written in the book called, *Barbarians at the Gate*, by Bryan Burrough and John Helyar). The RJR transaction also benefited the investment bankers and lawyers who advised KKR. These advisors walked away with more than US\$1 billion in fees.

During the 1980s, high-profile airline pursuits included TWA (featuring Frank Lorenzo and Carl Icahn) and Continental (with Frank Lorenzo once again, and David Bonderman of Texas Pacific Group).

### The Business Model

Once a targeted company was acquired by the private equity firm, the firm would restructure it, implement a series of cost-cutting measures and usually sell off underperforming assets. The new “leaner and more-efficient” company could then be resold, often at significant return on investment.

Now, 20 years later, the image of private equity has changed dramatically. The private equity “barbarians” are now shrewd global investment managers and specialists whose financial backers are looking for high ROI from acquisitions, spin-offs, re-financings and restructuring businesses. They also help

Private equity has become a fully fledged industry. Private equity firms made headlines in the airline industry last year. They were identified as firms to bail out ailing companies by providing management services, guidance and advice as well as looking for ways to increase shareholder value.

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out prominent U.S. and European carriers that were in financial trouble during the year.

“We believe UAL is a potential private equity play, given the US\$4 billion we estimate it can earn in free cash flow over the next four years,” Daniel McKenzie of Credit Suisse told *BusinessWeek*. McKenzie said such groups “could take UAL private today, collect dividends and go public when the industry consolidates, thereby capturing the valuation arbitrage.”

Private equity firms also rediscovered proven ways to unleash hidden shareholder value by attempting to spin off undervalued businesses within the airline’s portfolio, such as frequent flyer programs and regional feeder divisions.

### Opportunistic Focus Of Private Equity

Typical private equity opportunities, including those in aviation, fall into one of several categories:

- Leveraged buyouts and go-private transactions,
- Spin-offs and carve-outs from larger companies,
- Restructuring and recapitalization,
- Structured minority investments and strategic stakes,
- Financing acquisitions,
- Venture capital for new enterprises.

As “venture capitalists,” private equity firms may invest to create a new company or expand a smaller company that has undeveloped or a strong potential to grow revenues. For example, Apax Partners provided financial backing for the creation of Vueling Airlines, a Spanish low-cost carrier that was created in 2004. Apax Partners initially had a 40 percent interest in Vueling Airlines and sold its remain-

ing investment last year — around the time Apax Partners was rumored to be raising cash for a stake in Iberia.

TPG’s investment in Ryanair represents another start-up example. Ryanair President Michael O’Leary said, “He [Bonderman] got 20 percent for pretty much nothing. Sold us in ’97 and made a fortune.” The US\$42 million that Bonderman and his partners invested in Ryanair’s initial public offering of stock increased sevenfold.

Private equity firms invest in buy-out situations where they acquire a significant portion or a majority control in a mature company. Buy-outs usually involve a change of ownership. Some examples in 2007 included TPG’s unsuccessful attempts at Qantas and Iberia; and both TPG’s and Matlin-Patterson’s unsuccessful bids for Alitalia. Look for private equity firms to play a role in the coming years as speculation and action swirls around mergers and consolidation in the airline business.

### Unlocking Value

Blackstone Group got a quick return on invested capital after it bought Travelport — a reservations conglomerate that owns a majority stake in Orbitz Worldwide Inc. and Galileo and has agreed to buy Worldspan. Blackstone bought Travelport from Cendant in 2006, using US\$1.1 billion in debt to fund the purchase. Seven months after the deal with Cendant closed, Blackstone received a dividend equal to its debt. The company went on to file an initial public offering for Travelport last December. The IPO could raise US\$2 billion.

A go-private example is *Sabre Holdings*®, the publicly traded firm known for providing software solutions and consulting services to the travel industry that was purchased last year by TPG and Silverlake.

### Frequent Flyer Program Value

Airline	Estimated Value of FFP	Market capitalization of parent
Air Canada	C\$4.3 billion	C\$2.9 billion
United Airlines	US\$7.5 billion	US\$3.4 billion
Northwest Airlines	US\$6.4 billion	US\$2.9 billion
American Airlines	US\$5.7 billion	US\$3.3 billion
British Airways	£1.0 billion	£3.4 billion
Air France/KLM	€2.4 billion	€6.6 billion
Lufthansa German Airlines	€2.8 billion	€8.0 billion

Source: Bear, Sterns and Morgan Stanley, January 2008

Private equity firms have identified frequent flyer programs as hidden assets that can potentially be far more valuable to the firm if they were separated from the airline business.



## Private Equity Money

During the last two decades, the global private equity market has experienced explosive growth. New sources of liquidity created from rocketing oil prices and the developing Asian economies, among others, has been put into the hands of private equity firms.

Private equity has become an investment option for many of the world's largest investors, including pension funds, insurance companies, banks and university endowments. These institutions are committing an increasing proportion of their capital to private equity, which often outperforms more-established investment choices available.

## Private Equity Investments

Private equity firms generally receive a return on their investments through an IPO, a sale or merger of the company they control, or a recapitalization. Their offering of unlisted securities may be sold directly to investors through a private offering or to a private equity fund that collects contributions from smaller investors to create a capital pool.

Most private equity funds require significant initial investment, usually US\$1 million or more, plus further investment for the first few years of the fund.

Investments in limited partnerships, the dominant form of private equity investments, are typically illiquid — it is very difficult to gain access to money that is tied up in these long-term investments. Distributions are made only when investments are converted to cash. Limited partners typically have no right to demand that sales be made.

Private equity firms can provide high returns, with the best private managers significantly outperforming the public markets. Private equity fund investments are for those who can afford to have their capital locked in for long periods of time and who are able to risk losing significant amounts of money. This is balanced by the potential benefits of annual returns that range up to 30 percent for successful funds.

Given the risks associated with private equity investments, investors can lose all their investments if the fund invests in failing companies. The risk of loss of capital is typically higher in venture capital funds, which invest in companies during the earliest phases of their development, and lower in mezzanine capital funds, which provide interim investments to companies that have already proven their viability but have yet to raise money from public markets.

## Major Private Equity Players

The majority of investment in private equity funds comes from institutional investors including public pension funds and banks and financial institutions, which, together, provided 40 percent of all commitments made glob-



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**TPG, one of the most prominent private equity firms in the world, has invested in several airlines, including Continental Airlines, Southwest Airlines, Tiger Airways and Ryanair, giving it the most experience in the airline industry.**



ally according to data from London-based Private Equity Intelligence Ltd. Other prominent groups investing in private equity include corporate pension plans, insurance companies, endowments, family offices and foundations.

Last year, *Private Equity International* magazine published a ranking of the largest private equity firms in the world. The Carlyle Group was ranked the largest private equity firm, followed by KKR, Goldman Sachs Principal Investment Area, The Blackstone Group, TPG, Permira, Apax Partners, Bain Capital, Providence Equity Partners and CVC Capital Partners. The sector also includes multi-billion-dollar portfolios managed by Cerberus Capital Management, Summit Partners, Golden Gate Capital, Hellman & Friedman, and Equity Capital Markets Group, among others. Several of these firms and smaller private equity players, such as Yucaipa and Ranch Capital, have invested in the aviation sector.

## Investment Targets

Private equity firms share common themes to their strategies, objectives and approaches to investment:

- Identify out-of-favor, under-appreciated industries and businesses, and undervalued companies,
- Pursue opportunities to change the structure and profit potential of specific industry sectors through consolidation,
- Avoid short-term investments and trades; private equity firms are in it for the long haul.

While these may be stated objectives, private equity firms also are interested in making a quick return on investment. Many private equity firms play an active role in managing their investments, and there are certainly some common threads among the key players:

- Take a long-term view; be prepared to work with management through the inevitable ups and downs of business life to achieve objectives,
- Ensure there is active board participation,
- Provide expert resources and a network of advisors consisting of skilled former senior corporate executives,
- Work with management of the company and outside advisors on a plan to enhance the company's operations.

Obtaining financing is an important offering to a company about to be acquired or in need of financial assistance. Private equity firms offer:

- Financing expertise to lower the cost of capital, reduce risk and uncover hidden assets,
- Use of efficiencies of scale from investments across companies in an industry, such as combining purchasing power of goods and services at lower prices to achieve savings,

- Prudent capital investment, research and development, new product marketing, talent development, improved operations, and appropriate strategic acquisitions.

The degree of involvement is also likely to be related to the size of the investment made by the private equity firm.

## Private Equity Moves To Aviation Industry

With the airline industry posting profits in 2006 and 2007 amid strong demand and leaner costs as well as a stable outlook, airlines were potential targets for private equity firms.

"They've significantly picked up their interest from, say, five years ago," said John Luth, chief executive of transport-focused investment bank Seabury Group. "They're really open for business both here in the United States and elsewhere."

## North America

Last year, American Airlines' parent AMR Corp. came under pressure by its third-largest shareholder, the Icelandic investment firm FL Group. The investor wrote to AMR's board urging it to spin off American Airlines' frequent flyer program and make other disposals. Hannes Smarason, FL Group chief executive, said the carrier was burdened by a cluttered corporate structure that needed slimming down.

"There is no question that they have not been performing as well as they could have," Smarason told *The Guardian* last September. "If you have too complicated a structure and no one is responsible, then you have a problem and you need to clean it up."

FL Group said AMR's structure muddled the profitability of the company's constituent parts, a situation compounded by the fact that it does not publish details on individual units. Fort Worth, Texas-based American Airlines warned that third-quarter revenue growth would lag behind some rivals and rising fuel costs would affect earnings for the rest of the year.

FL Group had a history of investing in airlines, and at one point last year, it had an investment portfolio of approximately 25 percent of its assets in the industry. The FL Group has made a series of successful investments including the acquisition of Sterling Airlines, Scandinavia's largest low-cost airline, with its head office in Denmark, building a 23 percent stake in Finnair, the Finnish flag carrier. FL Group was the former sole owner of Icelandair, the Icelandic flag carrier and former owner of a 16.9 percent stake in easyJet.

On its easyJet stake, FL Group made a profit of €140 million (US\$207 million) when it was sold in April 2006. It also made a profit

of €305 million (US\$452 million) on its stake in Icelandair in 2006.

## Europe

In 2007, European Union transport ministers approved an open-skies agreement that went into effect in March. The agreement allows European carriers to operate flights to the United States that originate in cities outside their home countries. The agreement also makes it easier for European carriers to acquire airlines in other E.U. countries.

It was long thought that changes brought about by open skies would trigger consolidation among airlines in Europe. Some of the larger or financially weak airlines have been considered to be prime candidates for privatization and takeover, including Iberia and Alitalia, as well as state airlines Olympic and TAP.

Iberia has undergone a major restructuring in recent years. Its extensive Latin American route system, "would make a good network fit" for any of Europe's three bigger carriers, according to Andrew David Lobbenberg, a London analyst with ABN AMRO.

A consortium lead by British Airways and TPG (BA owned 10 percent of the Spanish carrier) made an initial bid for Iberia, and then withdrew, citing that "a bid under friendly terms was no longer possible," according to the Nov. 28 issue of *ATW Daily News*.

In Italy, private equity firms TPG and Matlin Patterson expressed interest to bid during the first round to purchase the Italian government's shares in Alitalia. However, the government's rules of procedure were considered onerous enough that they, as well as all the other bidders, withdrew their offers.

## Asia/Pacific

In November 2006, Australia's national flag carrier, Qantas, announced that it was the target of a takeover bid by a private equity consortium lead by TPG and the Australian bank, Macquarie. The deal was structured to give TPG about 15 percent voting interest and 25 percent of its earnings. The bid failed in April 2007 when the consortium could not gain the percent of shares needed to complete the takeover.

## Texas Pacific Group

TPG has the most experience in the airline industry among private equity firms. Its past and present investments in aviation include Continental Airlines, America West, Southwest Airlines, Ryanair, Tiger Airways, Midwest Air Group, *Sabre Holdings*, Hotwire and Gate Gourmet. Last year, TPG made bids to acquire Iberia, Alitalia and Qantas. One of TPG's founders, David Bonderman, is currently chairman of Ryanair.

TPG's buy-out of Continental Airlines in 1993 and then America West Airlines in 1994 became models for private equity investment.

## Private Equity Investments

Private Equity Firm	Aviation Acquisition or Investment	Notes
Carlyle Group	Acquired ARINC; July 2007	ARINC provides communications services to airlines
Kohlberg Kravis Roberts (KKR)	Sale of MRO company, ACTS (Aero Technical Support and Services Holdings)	ACTS is part of ACE Holdings, owner of Air Canada
Goldman Sachs	Considered PE investment in business-class airline	
The Blackstone Group	Purchased Cendant's Travelport company for US\$4.3 billion	
Apax Partners	PE funds to start Spain's LCC, Vueling in 2004	Considered bid for Iberia
FL Group	AMR, IcelandAir, Finnair, Sterling Airlines, easyJet	
Onex	Attempted hostile takeover of Air Canada/Canadian merger; teamed with Airline Partners Australia in takeover bid for Qantas	
Cerberus Capital Management	ACE Holdings, privatization of Debis AirFinance	
Indigo Partners LLC	Tiger Airways, Spirit Airlines	
Wexford Capital LLC	Republic Airways	
Yucaipa	2005 Aloha Airlines	
Ranch Capital LLC	Hawaiian Holdings	
MatlinPatterson Global Advisers LLC	Global Aero Logistics (ATA Airlines, North American Airlines and World Airways); Owned and sold VarigLog logistics business of Varig	Bid for Alitalia
TPG	Continental, AmericaWest, Southwest, Ryanair, Gate Gourmet, <i>Sabre Holdings</i> , Hotwire, Midwest Air Group, Tiger Airways	Bids in 2007 for Qantas, Iberia, Alitalia
Silverlake Partners	<i>Sabre Holdings</i>	partnered with TPG

Several of the world's top private equity firms have invested in travel-related companies, and many of them have current bids on the table to acquire additional businesses.

TPG's strategy was to invest in an airline emerging from bankruptcy during a cyclical downturn, oversee the carrier's turnaround and then cash out after the economy and company had recovered.

At the time TPG, which was named, "Best Global Firm of the Year" in 2006 by *Euromoney Magazine*, stepped in, Continental Airlines was ailing in a weak U.S. economy. The airline had been plagued with labor and customer service challenges. TPG's plan included bringing in a new management team that focused on improving customer yield, aircraft utilization and financial performance. It took rapid action to close unprofitable routes, shut down the airline's low-cost division (CALite) and reduce maintenance costs. The private equity firm addressed one of the primary customer complaints, moving Continental Airlines from consistently near the bottom of the on-time departures table to consistently in the top three by creating financial incentives for front-line staff. At the same time, TPG

built up the carrier's Houston, Texas; Newark, New Jersey; and Cleveland, Ohio, hubs and upgraded the fleet.

TPG's founders spent years on its turnaround. Eventually, it was rewarded with extraordinary returns on investment. Thanks to a clever purchasing arrangement, TPG's partnership controlled Continental Airlines, although it owned only 14 percent of its stock. Continental's share price, once as low as US\$2, soared to US\$65 by 1998.

"It was a huge gamble with an even larger payoff in an industry where net profits are close to zero," said Continental Airlines board member George Parker.

After eight years, TPG's total return on its US\$66 million investment was nearly US\$700 million.

TPG's partners get high grades from airline insiders for its knowledge of the industry and eye for executive talent. Before any major investment, the company's executives walk the halls of the business, checking out

employee morale and even the photos on executives' walls.

Bonderman and his partners believe this is prime time for long-term-value investors.

"There's a lot of trouble in the world, but it is also a potential time of value," said TPG co-founder James Coulter. "As investors, we like this environment better than the bubble. It may stay rough for a while, but we're focused five years out."

Some of TPG's recent targets have been challenging. On the success side, TPG and Northwest Airlines acquired Midwest Airlines earlier this year (see cover story on page 36), in the airline's effort to stave off an unfriendly takeover bid by AirTran Airways. However, there were unsuccessful bids that were publicized last year, such as TPG's deal in conjunction with Australia's Macquarie Bank for Qantas Airways, which was rejected by the Australian carrier's owners in March 2007, as well as the attempted bids on Iberia and Alitalia.



**FFP Spin-Offs**

Private equity firms and investors have found that airlines may have hidden assets that could be worth as much as or more than the carriers themselves. The crown jewels — airlines’ frequent flyer programs.

The underlying concept to this hidden wealth is that a stand-alone frequent-flyer business, with its high margins, good growth prospects and steady cash flows, would trade at a much greater multiple to earnings when separated from the airline business.

The theory is relatively simple: Unlike airlines, loyalty programs tend to be stable, cash-producing businesses with low fixed costs and substantial growth opportunities. Separating them from their riskier airline gives investors direct access to the business, resulting in a higher valuation.

The airline would benefit by getting cash from the FFP sale, and it could still collect profits by keeping a share in the program while the FFP grows. Once out of the airline’s control, mileage programs could move outside the air travel industry and add retail partners and attract more members.

The success story and model for determining FFP value is Air Canada’s Aeroplan. Prior to 2002, Aeroplan was integrated with Air Canada. Aeroplan became a wholly owned, limited partnership of Air Canada in 2002. It was spun off in an initial public offering in 2005 and had an initial valuation of C\$2 billion (US\$ 1.9 billion). It has since doubled in value to about C\$4.3 billion (US\$ 4.2 billion) compared with the market cap of C\$ 2.9 billion (US\$ 2.8 billion) for ACE, Air Canada’s holding company.

“Creating a separate structure made Aeroplan a better business with more freedom to add partners and grow,” said Karl Moore, a professor at McGill University in Montreal who worked with the mileage plan’s executives on business school projects. “It unleashed an enormous amount of capital that they [ACE] wouldn’t have otherwise had.”

Qantas Airways has met with Aeroplan to discuss how to release value from its rewards plans. The carrier may find a buyer in Aeroplan, and the frequent flyer program’s chief executive officer, Rupert Duchesne, said in an interview in last August that Aeroplan was in talks to buy stakes in other loyalty programs.

American Airlines’ FFP, AAdvantage, which could be worth as much as US\$5.7 billion, according to a Morgan Stanley estimate, was under pressure to be sold last year. That amount is about the same as the market value of parent company, AMR.

FL Group, which at one point owned 9.1 percent of AMR, urged American Airlines to sell its frequent-flyer program in an open letter to the AMR board last September.

“This has the potential to become a sustainable source of value creation if it’s

**Size Of Investment**



The degree of involvement a private equity firm has when acquiring a company depends on the size of its investment.

done in the right way,” said Smarason, the FL Group’s chief executive. In the letter to AMR’s board, Smarason said, “... our conservative analysis indicates the unbundling of AAdvantage could lead to value creation of US\$4 billion.”

This was based on FL Group’s estimate of US\$6 billion business valuation offset against a cost of US\$2 billion to decouple from American Airlines. FL Group also encouraged AMR to sell its feeder business, American Eagle.

Citi analyst Andrew Light said it would be “much easier” to divest American Eagle than AAdvantage because the carrier is run as a separate entity. Similarly, airlines such as Continental Airlines, Delta Air Lines and Northwest Airlines have spun off or sold regional carriers.

“As with Air Canada’s Aeroplan, stripping out the frequent flyer program would leave a barely profitable, volatile and poorly valued core airline,” Light said.

“Spinning out the mileage programs would be very beneficial to shareholders,” said Craig Hall, a Dallas investor who owns the fifth-biggest stake in AMR and wants American Airlines to divest AAdvantage. Hall calls the frequent flyer plans a “hidden asset” not reflected in airline valuations.

Several major airlines have since examined setting up their FFPs as separate companies. However, there are some concerns. The cost of spin-off is steep. In the AAdvantage case, the cost was estimated at US\$2 billion. In addition,

spinning off FFPs may make the core airline parent less attractive (valuable) to investors.

**Mining Gold**

Private equity firms represent a global, sophisticated industry. They follow traditional “buy low, sell high” investment advice and have a history of out performing other investment categories for the private investors who fund these firms.

The aviation industry has provided opportunities for this group to mine gold. Just like mining, there can often be long, hard work to achieve good payouts, as well as the occasional nugget that was there for the taking. Challenges include finding undervalued companies or hidden businesses that could be spun off for large gains, such as frequent flyer programs, and then getting the green light to go forward to restructure, refinance and spin off value to shareholders and investors.

Private equity may well continue to play an active role as airline consolidation rumors began to swirl earlier this year. ■

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