

A MAGAZINE FOR AIRLINE EXECUTIVES

2010 Issue No. 2

ascend

Taking your airline to new heights



A TOP CONTENDER

A Conversation With ...
Enrique Cueto, Chief
Executive Officer, LAN
Page 12.

18 Cambodia has a new, proud national flag carrier

41 A new era in airline technology is upon us

76 single, robust platform

The background features a complex, abstract design. It consists of thick, golden, wavy lines that resemble liquid or smoke, flowing across the frame. These lines are set against a light beige background with several large, white, geometric shapes that look like recessed rectangular panels or architectural elements. The overall aesthetic is modern and sophisticated.

THE NEW NORMAL

Barring government intervention, the airline industry can expect a vastly changed landscape with mergers on the rise.

■ By Lynne Clark | *Ascend Staff*

The media's latest buzz phrase, "the new normal," is pithy shorthand for more off-putting words such as "change," "flexibility," "uncertainty" and "transition." Roughly translated, it means when the recession is over, things won't go back to the way they were before.

For the airline industry, which has suffered losses during the past decade of US\$70 billion, most government leaders, airline executives, union members, analysts, stockholders and even the traveling public agree that a new normal couldn't possibly be worse than the old normal. The groups diverge, however, when discussing how the new normal industry should look in the coming years. The conversation is heating up now especially in light of the mergers of UAL Corp.'s United Airlines and Continental Airlines, Inc., and British Airways and Iberia.

The United/Continental merger — valued at more than US\$3.2 billion — is moving forward following shareholder and regulatory approval. It will create the world's largest global carrier, with combined annual revenue of US\$29 billion.

The British Airways/Iberia union — valued at US\$7.5 billion — approved by the European Union, is also expected to close by the end of the year. Under the merger agreement, British Airways and Iberia will keep their separate brands and identities, but a holding company called International Consolidated Airlines Group SA would be created with a primary listing in London and a listing in Spain. The combined airline would be the third-largest airline in Europe by revenue and would carry more than 58 million passengers a year.

Ripe For Mergers

These mergers are just the latest in a spate of airline consolidations that have grown more commonplace in the aftermath of crippling events such as 9/11, SARS and record-breaking fuel prices. Since late 2008, for example, Lufthansa — which absorbed Swiss International airlines in 2005 — has acquired Brussels Airlines, Austrian Airlines and, last year, took full control of its bmi subsidiary. Delta Air Lines and Northwest Airlines merged in 2008 and last year reached an expanded partnership agreement with Air France-KLM that seeks to control about 25 percent of passenger flight capacity between the United States and Europe. And in the last few weeks, South American carriers LAN and TAM and North American LCCs Southwest Airlines and AirTran Airways have announced merger plans.

Analysts say next year is ripe for more merger deals. In June, Qantas Airways Ltd. and Virgin Atlantic Airways Ltd. said they're open to merger proposals to further efforts to cut costs and boost traffic. Their list of possible marriage partners is growing as previously unprofitable smaller carriers shore up their bottom lines. Those open to courting include Malaysian Airline System Bhd., Scandinavia's SAS and Poland's LOT.

With most traditional carriers teaming up, the only obvious U.S. network carrier combination left is American Airlines and US Airways. Experts who have studied the industry's current condition and future prospects say that unless American and US Airways can find a way to combine with each other, their prospects are bleak. But American Chief Executive Officer Gerard Arpey has repeatedly dismissed the arguments.

"I was asked that question in Los Angeles a couple weeks ago at a **oneworld** meeting that we had," he told reporters in May when asked about the inevitability of an American Airlines merger. "I guess I would express the same view I did then, which is that I think that we have a strong network today; I'm confident in our cornerstone strategy because I think our footprint is in the most important business markets in the United States already. We're not necessarily threatened by talk of consolidation in the industry; in fact I think Tom [American Airlines Chief Financial Officer Thomas Horton] and I both commented publicly about the fact that consolidation could be good for the industry."

He maintains the trans-Atlantic partnerships with British Airways and Iberia would be "a big step forward on the revenue side," thus eliminating the merger pressure.

Low-cost carriers, though not as hard hit, are not immune to mergers. Last April, Republic Airways announced the fate of its two holdings: Frontier Airlines and Midwest Airlines. Both airlines will combine into one, keeping the name Frontier Airlines, although it will retain Midwest's famous chocolate chip cookies. The headlines for possible consolidation talks among Alaska Airlines, JetBlue and Air Canada could prove interesting.

"Given the ferocity of competition in established and emerging markets, over capacity on many key routes, intractable fixed asset costs and high-leverage fuel pricing and hedging risks, strong unions, and softening long-haul revenues, it's no surprise airlines are revisiting their business models," said Gary Bowerman, travel writer and industry observer.

Consolidation Is Inevitable

Pro-merger advocates argue consolidation through mergers is inevitable for an industry that can't get to sustained profitability even after more than a decade of cost slashing, capacity cutting and postponing investments in aircraft, facilities and other expenditures.

"Mergers and consolidation is a must," said Giovanni Bisignani, IATA's director general and chief executive officer. "No other industry is so fragmented, so we have to consolidate in order to build more efficiency."

Bisignani has called for regulatory support for barrier-free mergers across borders, explaining that different legal frameworks have hindered extensive global industry consolidation, particularly among U.S. and European carriers.

"I am raising the agenda of freedom on consolidation because we cannot do the same thing



Photo: Newcast

According to industry analysts, 2011 is ripe for more mergers in the airline industry. In recent months, Qantas Airways Ltd. and Virgin Atlantic Airways Ltd. said they're open to merger proposals and each has a growing list of prospective partners.

(as in Europe where some cross-border mergers have been helped by unified legal frameworks) between an American and a European carrier," he said.

Most industry observers agree consolidation is key to survival.

"Airlines look at consolidation as a solution, or perhaps just the last arrow they have in the quiver," Wall Street Journal Travel Editor Scott McCartney wrote in an April post to his blog, The Middle Seat. "In a network business, like aviation or phones or banks for that matter, the bigger and broader your network is, the more revenue you can capture. Two airlines combining their customer bases and networks can do better, especially since they aren't competing against each other."

Adding to the ripe environment for mergers is the number of open labor contracts. The Air Line Pilots Association is in bargaining with half of the 38 airlines where it represents pilots. Perhaps, surprisingly, ALPA head Captain John Prater told reporters early this year that consolidation is "inevitable."

"We're for the right consolidation, consolidation that actually protects and enhances jobs and creates a profitable carrier," he told reporters in New York.

Some industry experts believe mergers are the only solution to getting rid of what they say is the underlying industry problem: overcapacity.

"In the final analysis, the industry tends to produce seat capacity beyond the level that would allow the industry to earn a rate of return that attracts and maintains shareholder support," Vaughn Cordle, CFA Airline Forecasts, LLC wrote in a June article published by Centre for Asia Pacific Aviation.

"I term this phenomenon the 'destructive growth prerogative.' Without capacity discipline — and this requires an elimination of excess capacity in the system — the industry will continue to destroy economic and shareholder value and, as a result, the quality of the product will only get worse.

"Letting the number of legacy carriers shrink to a sustainable level of as few as three healthy ones might be the best way to ensure that fliers can get services they have lacked for so long," Cordle wrote.

Bad For Consumers

Merger opponents argue that mergers don't always work to fix what ails the airline industry, that they cannibalize market share and are harmful to the flying public.

A long-time and vocal opponent to consolidation is James Oberstar, representative of the U.S. state of Minnesota and chairman of the House Committee on Transportation and Infrastructure.

"This is the antithesis of the structure I voted for when Congress deregulated the industry in 1978," he said in a May editorial released



Photo: Newcast



Photo: Airbus

British Airways and Iberia, under a merger valued at US\$75 billion, intend to keep their separate brands and identities, but a holding company called International Consolidated Airlines Group SA will be created with a primary listing in London and a listing in Spain. The merged carriers make up the third-largest airline in Europe by revenue and expect to carry more than 58 million passengers annually.

to news organizations. "Deregulation promised robust competition and innovation — not market domination by a few powerful carriers."

His opposition has gone so far as to threaten industry re-regulation.

"Hardly a day passes by where I don't walk out on the floor that someone asks me, 'When are we going to re-regulate the airlines?'" he said.

Oberstar's sentiments were echoed by machinist union head Robert Roach Jr., who was the only labor representative to testify at the House hearings.

"The Machinists Union opposed deregulation in the 1970s and have been calling for re-regulation ever since," he said. "It is clear that airline deregulation has failed to deliver on its promises of a stable and profitably industry."

At a June hearing of the U.S. Senate Committee on Commerce, Science and Transportation, more than a few senators shared concerns of House members and those testifying against the United/Continental merger.

"I have never been a big fan of mergers," U.S. Sen. Byron Dorgan told Continental Chief Executive Officer Jeff Smisek and United CEO Glenn Tilton, who were testifying before the committee.

Dorgan said he was concerned about passenger safety, citing the airline practice of outsourcing flights to smaller subcontractors. He blamed the process for the 2009 fatal crash of Colgan Flight 3407, marketed as a Continental flight. It crashed upon approach to Buffalo, N.Y., in a February winter storm.

"The crash, in many ways, was an issue of size," he said.

U.S. Sen. Kay Bailey Hutchison, representative of the U.S. state of Texas, told the CEOs she was concerned about the merger's impact on Continental's headquarters in Houston. Under the merger, Continental is moving its headquarters to Chicago, costing jobs in Houston. Sen. Hutchison also voiced concern that the merger would mean loss of service to smaller community airports.

While many opinions and opposition on the controversial topic of airline mergers exist, one thing remains ... what was once "the norm" is now basically unrecognizable. Fasten your seatbelts and get ready for a "new normal" in the airline industry. **F**

Lynne Clark can be contacted at wearelistening@sabre.com.