A Conversation with Abdul Wahab Teffaha, Secretary General Arab Air Carriers Organization.

Carriers can quickly recover from irregular operations

Singapore Airlines makes aviation history

High-speed trains impact Europe’s airlines
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 airline 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.

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.

Selected Merger and Acquisition Examples

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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.
"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.
- 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 of 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 effects on operations and customer satisfaction.

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...
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.

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**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 would reinforce the need for consolidation. They wanted to take advantage of changes about to take place the in 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.
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 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.” 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; estimated annual value of synergies produced by the fifth year is based on a 2003 presentation entitled, “Creating Europe’s Leading Airline.”
- **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 €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).
- **Fleet rationalization:** 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 flight 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 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 antitrust 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. **“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.”**

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