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Friendlier Skies

by Jürgen Ringbeck and Stephan Gross

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Consolidation in the increasingly competitive European airline industry has been long delayed, but the wait is coming to an end.

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In 2004, when French flag carrier Air France and its Dutch counterpart KLM merged, it was the first major European airline merger in decades. Despite some initial skepticism from investors, the resulting company has realized much of the potential that had originally prompted the merger. Over the past year alone, operating profits rose by 32.5 percent on a 7.6 percent increase in revenues. Similarly, in 2005, German flag carrier Lufthansa merged with SWISS (Swiss International Air Lines), which had emerged from the bankruptcy of Swissair soon after the September 11, 2001 (9/11), terrorist attacks. So far, Lufthansa and SWISS have also each shown strong results.

Yet despite the benefits each of these new entities has reaped since its merger, there has been virtually no other M&A activity in the European airline industry for more than a decade. Any other sector would have begun to consolidate years ago, given the challenging economic environment in which airlines around the world have found themselves since 9/11 — marked by lower consumer spending, customers' increased reluctance to fly due to security concerns, and corporate cost cutting that has reduced business travel. Even the European airline industry's successful results in 2007 hide serious problems. Altogether, the industry took in an estimated €3 billion (US$4.4 billion) in operating profits (after taxes and interest), compared with cumulative operating losses totaling €2.8 billion ($3.7 billion) between 2000 and 2006. Yet that €3 billion breaks down to an average of just 4 percent of a typical airline's revenue, significantly below the 7 to 8 percent usually required merely to cover the cost of capital. Worse, rising fuel prices and the mounting global credit crisis will likely make it difficult to maintain even those slim profit margins. Indeed, the industry's trade association, the International Air Transport Association, adjusted its profitability outlook for its members three times between June and December 2007, lowering estimates by a total of around 50 percent, and is predicting a further slowdown in 2008, citing jet fuel prices and the risk of the U.S. economy falling into recession.

Given the challenges of maintaining profitability, why haven't other carriers followed Lufthansa and SWISS and Air France and KLM down the merger path? The reasons are twofold: Flag-carrier airlines operate in a political and cultural environment that is hostile to deal making, however economically rational the deals may be. And even as the European Union continues to push for more mergers, tensions remain between EU rules and the policies of national governments. One issue, for instance, is whether flag carriers at risk of bankruptcy should continue to receive national subsidies — a pri-

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mary cause of the recent breakdown in merger talks between the Air France KLM Group and Italy's Alitalia.

We expect the picture will change soon, however. Two major factors are now producing the conditions that will make merger activity much more likely. And that, we believe, offers potential to create a significantly more stable and profitable future for the industry.

The first factor is the worsening economics of the airline business, due primarily to high fuel prices. Fuel makes up more than 30 percent of the average airline's costs, and as prices continue to skyrocket, every airline will be searching for ways to reduce expenses. When it comes to lowering costs, the major flag carriers have an advantage thanks to their long-term development of economies of scale and the efficiency of their hub-and-spoke systems. Indeed, because of productive global alliances made in the 1990s and their more recent acquisitions, the three leading European airlines — British Airways, Air France KLM, and Lufthansa Group — now boast a market share of 47 percent of the passengers carried by European flag carriers.

At the same time, even as Europe's low-cost carriers (LCCs) continue to gain market share, they will also suffer in a downturn. As fuel prices rise, it will be critical for LCCs to consolidate to create the greatest economies of scale possible and to make further gains against the flag carriers, especially since they have already squeezed every possible savings out of their operations.

The second factor is the changing competitive dynamics of the international air travel business. Pending consolidation among U.S. airlines will strengthen their position on routes to Europe, and airlines in emerging markets, such as Air China and Emirates, are seeking greater access to European markets. Looser regulations — most notably the recent Open Skies agreement between the U.S. and the European Union, which permits U.S. and European airlines to make transatlantic flights between any two airports in each region — mean the European flag carriers are facing greater competition. That will lead to more transactions like Lufthansa's recent purchase of 19 percent of New York–based JetBlue, which is expected to give Lufthansa more feeder routes into its transatlantic system. If successful, this deal may encourage European flag carriers to take minority ownerships in U.S. airlines.

The Shape of Things to Come

Given these trends, any number of smaller European airlines, both flag carriers and LCCs, may find themselves on the auction block in the coming years. The three major LCCs — Ryanair, easyJet, and Air Berlin — together offer more than 60 percent of the LCC seats available in the European market. They will likely seek to acquire other niche LCCs as they drive to capture new routes and markets.

Similarly, although initial negotiations between Air France KLM and Alitalia broke down, the three major flag carriers will likely eye deals with smaller flag carriers, including Alitalia, as well as airlines such as Iberia and Austrian Airlines: Most of these small lines are undercapitalized, unprofitable, and burdened with suboptimal networks and legacy cost structures. Already, British Airways is exploring an expansion of its minority stake in Iberia. Lufthansa would most likely be open for discussions with its fellow members of the Star Alliance, such as BMI (British Midland Airways), Austrian Airlines, LOT (Polish Airlines), and SAS (Scandinavian Airlines).

We also think it likely that the factors encouraging the coming consolidation will promote deals across industry categories, leading to convergence among intercontinental network carriers and LCCs and creating innovative hybrid models with the potential to generate higher rates of return. Lufthansa and Germany-based travel tour operator TUI have already signed a letter of intent to set up a new LCC to compete with Air Berlin. Meanwhile, Air Berlin recently acquired the long-haul German charter carrier LTU and is in the process of acquiring Condor, another German LCC, in hopes of creating an international network based in Germany that would combine a strong European network with a growing number of intercontinental destinations; indeed, Air Berlin recently announced plans to begin regular flights to China. Other LCCs, including Ryanair and Italy's Air One, are also looking beyond their discount European business to a greater international presence.

A Blueprint for Success

The difficulty in any airline merger, of course, lies in overcoming the numerous obstacles — financial, political, cultural, regulatory — that stand in the way, and then successfully capturing the potential value inherent in any such transaction. The merger of Lufthansa and SWISS has cleared those hurdles and thus far exemplifies a successful transaction.

Despite its proud history of customer service, the venerable Swissair fell into bankruptcy in 2001, due to a failed expansion strategy and the air travel downturn that followed the 9/11 attacks. After a painful restructuring, the airline was reborn as SWISS, but that experience provided the motivation for both management and employees to enter merger discussions with Lufthansa, and the close cultural fit — created by a mutual drive toward quality and a strong technology footprint — between the two airlines further smoothed the path.

The result was a deal crafted to find the upside for both partners, according to Stephan Gemkow, CFO of Lufthansa Group, beginning with the effort to rethink both airlines' route networks and sales strategies. SWISS kept its strong brand and its intercontinental hub in Zurich, and the combined company realigned its international routes to avoid redundancies and maximize yield, allowing SWISS's customers to take advantage of broader choices to international destinations on either airline. Meanwhile, Lufthansa and SWISS integrated many of their frequent-flier programs and sales forces. Together, the combined airlines have reaped more than €420 million ($662 million) from the financial synergies created by the deal, nearly 60 percent of which came from SWISS. Revenues at SWISS, which still operates under its own brand, have grown from CHF 3.6 billion ($3.2 billion) in 2004 to an estimated CHF 4.4 billion in 2007 ($3.9 billion), and its loss of CHF 140 million ($122 million) in 2004 has improved to an estimated profit of more than CHF 500 million ($441 million) in 2007. Meanwhile, for Lufthansa Group as a whole, revenues have increased from €17.0 billion ($23.0 billion) to €22.4 billion ($32.7 billion) during the same period, while net profit has gone up from €404 million ($547 million) to €1.7 billion ($2.4 billion).

Yet Lufthansa Group has no intention of resting on its laurels. The company plans to further optimize its route networks for additional savings, to expand its frequent-flier program, and to increase its efforts to integrate the sales force. In addition, the integration of back-office functions, such as purchasing and IT, should generate additional gains, as will combining financing activities such as leasing and fuel price hedging, which remained unconsolidated until late 2007.

As with any industry facing intense competition and escalating costs, market power and scale are the keys to survival. The mergers of Air France and KLM and Lufthansa and SWISS show that it is possible for two flag carriers to work together to boost their competitive positions, and thus to face the future in a stronger position. We expect to see more such deals. +

Resources

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