# AIRLINE CHOICES FOR THE FUTURE: FROM ALLIANCES TO MERGERS

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**ABSTRACT**
The Air France-KLM merger, followed suit by the Lufthansa-Swiss merger announcement, has changed the landscape of air transport and set the foundation stone towards air transport consolidation. Once considered a remote eventuality, cross-border mergers and the potential they represent have become a concrete possible source of competitive advantage in the search of efficiencies and synergies in a highly competitive and volatile air transport arena. The present paper attempts to assess how the members of the three strategic alliances (Star Alliance, oneworld and SkyTeam) perceive alliance evolution and merger prospects under the impact of these developments. Through a questionnaire survey, the paper analyzes how airlines themselves view mergers, what benefits mergers can offer as well as the obstacles they might encounter and in which areas these benefits and/or problems could arise. It further asked participants to assess how fast consolidation will move, what role alliances will play in the emerging restructured air transport industry and how alliances and mergers will interact. As it is the very first survey to focus on and analyze cross-border mergers from the industry's point of view, its findings are of great interest not only to the industry itself but to governments, competition authorities, academics and to all those directly or indirectly involved in and/or influenced by developments in air transport.

## 1. INTRODUCTION

In the last decade, air transport area has been characterized by the dramatic proliferation of cooperative agreements between airlines; whether these have been concluded in an effort by the participating airlines to strengthen their position in the market or to simply secure the market they already control, they have changed the air transport structure for ever.

Global alliances have developed in response to the economic demand of global markets and to the opportunities provided by deregulation and liberalization initiatives. These cooperative agreements initially took the form of simple code share agreements; but as deregulation started to take effect in the European Union and a Single Internal European Aviation Market was created and as the US authorities pursued more "open" and less restrictive bilateral air services with other countries, the horizontal links between carriers took the form of deeper and more complex cooperation.

There are many that have argued that airline alliances are simply a second best solution, the only viable alternative, because had it not been for the regulatory constraints which make a carrier's traffic rights dependent on the nationality of its ownership, airlines would have moved to mergers, which seem to hold the promise of efficiencies, synergies, cost reductions, scale benefits and better control over operations.

In this paper the executives of the airlines that are part of the strategic alliances express their opinion regarding cross-border mergers and how such developments can influence not only their own airline but also the future air transport structure.

A comprehensive survey of airlines participating in the three global strategic alliances was carried out between December 2005 and March 2006.

The heads of the alliance and marketing departments of all airlines – that is 32 carriers[6] at the time of the survey – belonging to the alliance groupings of Star Alliance, oneworld and SkyTeam were contacted to participate in a questionnaire survey. The questionnaire focused on the impact of cross-border mergers on airline operations, on how mergers interact with alliances and on the possible course the through mergers restructuring development will follow. 31 carriers participated in the research giving the survey a 97% response rate. The only airline that refused to participate in the survey is British Airways.

[6] The only carrier that was excluded from the survey was TAP Air Portugal because it has been a member of Star Alliance for less than a year.

## 2. AIRLINES' PERCEPTION OF THE DRIVE TOWARDS CONSOLIDATION

The first series of questions attempted to examine how the airlines view the potential of mergers, that is, to identify whether they believe that there is indeed an imminent wave of cross-border mergers and a consequent restructuring of the air transport system. 75% of the airlines say that consolidation is slowly but surely gaining momentum but only 13% believe that there is a strong drive towards a more consolidated industry (figure 1). The answers given are somewhat differentiated from those given two years ago (Iatrou 2004), when 60% of the respondents of a survey on alliances had stated that alliances were the final destination of airline cooperation. It should be born in mind though that after 2001 airlines worldwide, confronted with falling demand, faced serious financial problems, which forced them to concentrate on efforts to secure their survival, to adopt massive cost-cutting programmes and therefore moved more cautiously on cooperation strategy. It is only during the last year, now that that most airlines have set their house straight, that the economic situation seems to stabilize – despite the spiralling increase of fuel – and traffic is on the increase, and that the balance of power and the distribution of partners among alliances seems to even out, that airlines have begun again to look around for cross-border mutually profitable forms of cooperation.

**Figure 1: Is the air transport industry moving towards consolidation?**

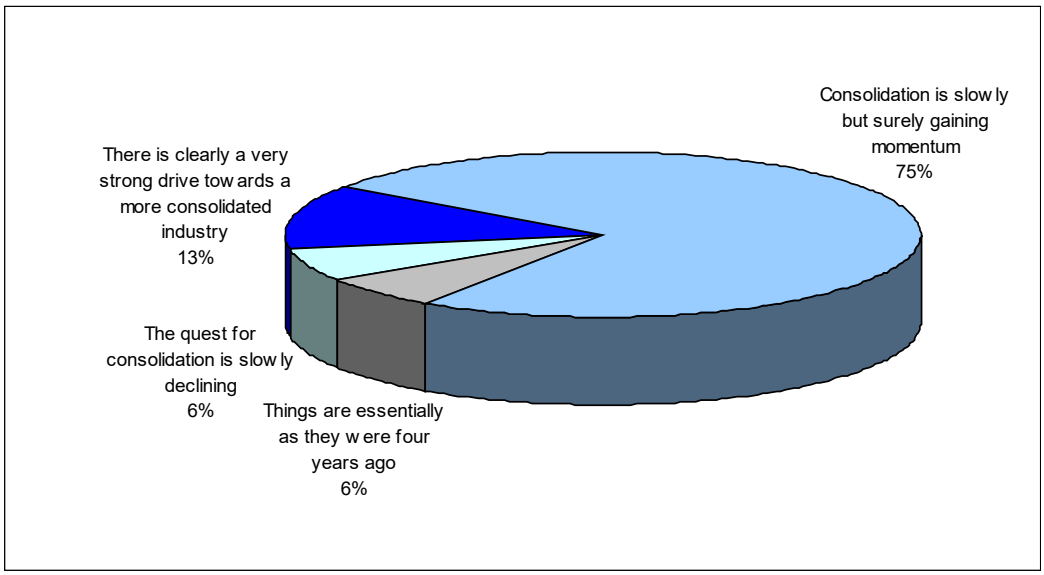
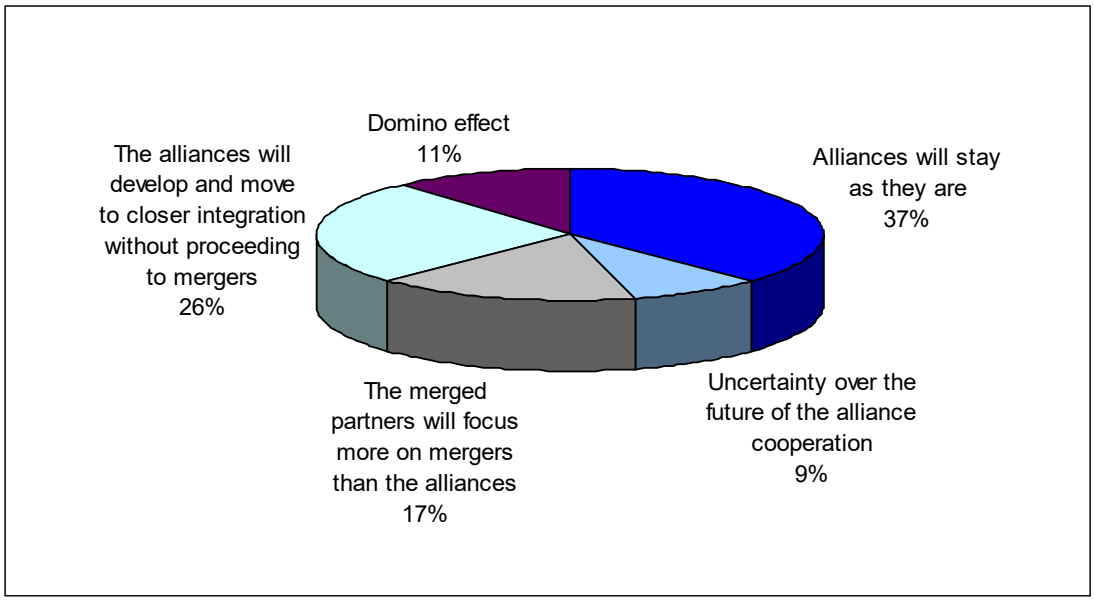


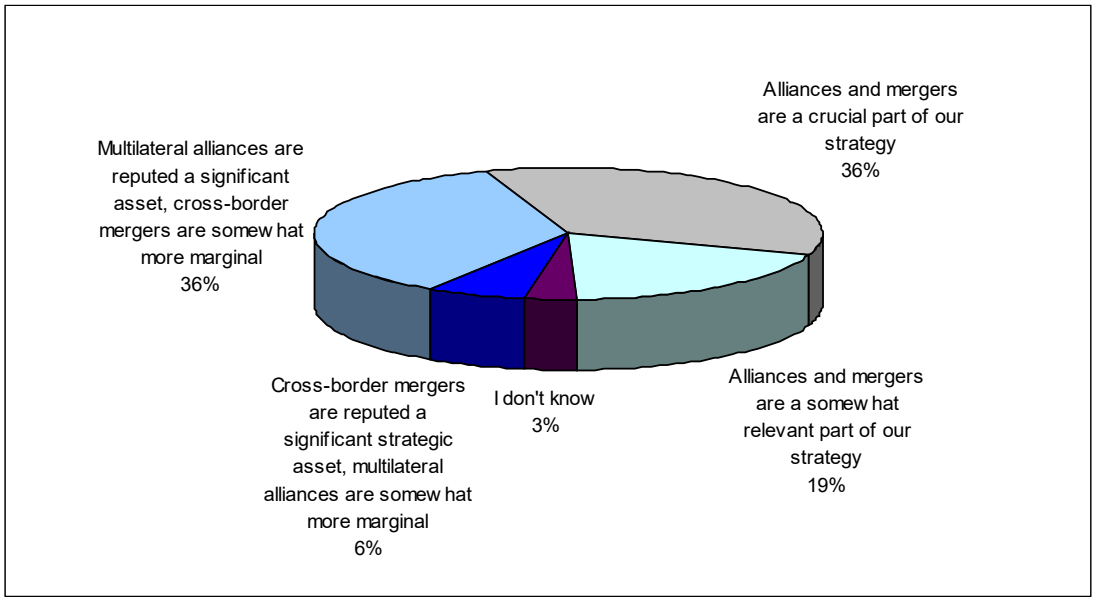

**Figure 2: What is the future of alliances in relation to mergers?**



Despite the fact that the respondents agree that mergers do gain momentum, 37% of them have stated that alliances will stay as they are and 26% believe that alliances will continue to develop and move to closer integration without proceeding to mergers (figure 2). These answers may seem contradictory on the surface but on a deeper level they may simply mean that mergers and alliances will co-exist. The small percentage of airlines that express an uncertainty over the future of alliances perhaps represent those airlines looking around for realignment. Finally, 17% say that the merged airlines will focus more on mergers than alliances. This low percentage clearly shows that mergers will not disturb the smooth functioning of alliances and there will be no reaction from the other partners in the alliance. What however becomes evident from these answers is that further integration, whether it will take the form of mergers or of closer cooperation between allied partners, is the new rule of the game in the air transport arena.

Alliances, as it can be seen in figure 3, play a very important role in the strategic plans of airlines. But what is much more intriguing is that 36% believe also that mergers are a crucial part of their strategy and 6% of the carriers give precedence to mergers over alliances as a significant strategic move. That gives us 42%, which means that almost half of the airlines participating in alliances are, one way or the other, contemplating the possibility of mergers. There is certainly, at the same time, 36% of the respondents who believe that cross-border mergers are somewhat more marginal and put a premium on alliances and this finding is confirmed by the fact that 65% mention that cross-border mergers are a choice for the airlines and not a necessity.

**Figure 3: Are mergers/alliances a significant part of the airline strategy?**



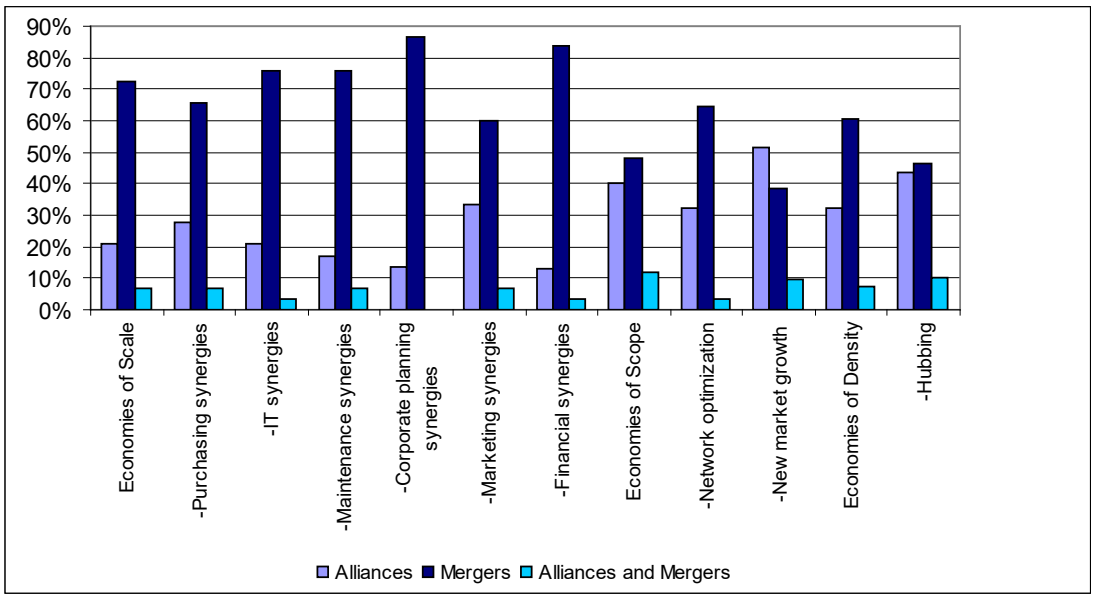

***The impact of alliances and cross-border mergers on airline performance***

Mergers as a form of airline cooperation largely outweigh alliances in the production of positive effects on airline operations (figure 4). The only category in which alliances present more positive aspects is in that of economies of scope and more specifically in the subcategory of new market growth; a quite plausible finding since a merged carrier, no matter how large the merged airlines are, cannot match the network reach of a eight- nine- or sixteen-member alliance. After all, the main drive behind alliance formation was, as the airlines themselves stated, the desire to expand their geographic scope of their network so as to achieve global scale (Iatrou, 2004). In the area of hubbing, the results do not give a clear precedence in one form of cooperation over the other. Alliances have so far operated in a way so as to take the most out of the hubbing system and the resulting economies of density with each partner feeding traffic to the other. A merger will most probably entail network integration, even network rationalization, which may mean that the overall network structure may change and some airports may loose connections while others may have more connections. Although it is much more efficient to close a duplicating hub and concentrate resources on the stronger one (Duedden, 2005), it is not certain that the merged airline will reduce the number of hubs as other aviation experts claim that mergers would lead to an increase in the use of the hubs of the two merged carriers. But in polycentric regions such as Central Europe other means of transport, especially trains, may replace aircraft to the detriment of smaller hubs, which will be downgraded, at best, to regional feeders to the big players that control the large hubs. In other words it

remains to be seen whether the merged partners will maximize economies of density out of a single hub or they will pursue a multi-hub strategy selling it as a competitive advantage and positive differentiation criterion.

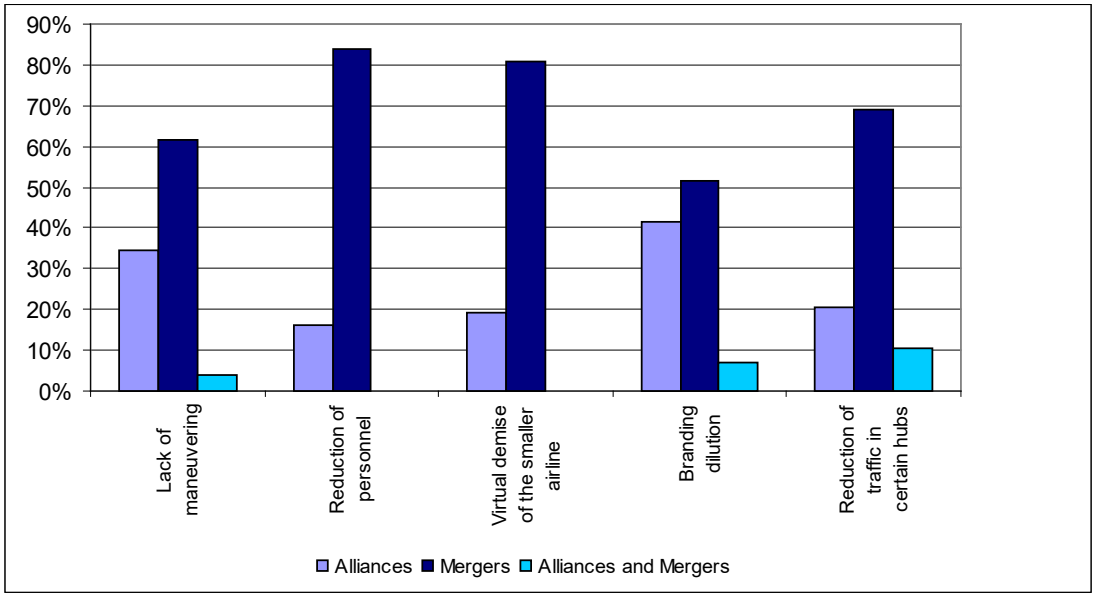
The most positive aspects of mergers appear, according to the respondents, in the area of economies of scale: corporate planning synergies followed by financial synergies, IT synergies and maintenance synergies. It seems that a strategic alliance does not allow the same type of cost synergies of a full merger. This result clears shows that alliances have not been able to produce significant benefits in the area of cost synergies. None of the three major alliances have yet engaged actively in joint purchase of aircraft or in joint investments in information technology systems and customer databases, all those cooperation aspects that promise cost-effectiveness. All respondents agree that only cross-border mergers can more effectively bring about scale benefits and synergies as well as better quality decision making.

**Figure 4: Benefits of alliances and cross-border mergers on airline operations**




It is not the positive impact of mergers but also their negative aspects that are by far greater than those of alliances, with the reduction of personnel being the most negative (figure 5). Labour costs are certainly the single most important component of total airline costs, accounting for 25-30% of total operating costs and all airline management would like to reduce it but they know very well that, given the unique leverage airline unions enjoy, this cannot be achieved without serious social and even political reaction. The second most adverse negative aspect of mergers is the threat posed to the existence of the acquired airline, as the mergers of two airlines would result in the demise of the smaller carrier. Next in ranking as the most negative aspect of mergers is the reduction of traffic in certain hubs since it is expected that the new merged entity will concentrate on exploiting the traffic out of the hub that will be the most profitable for the new company. Interestingly enough, the idea of brand dissolution does not appear to be considered a serious problem by the respondents whether in the case of alliances or mergers.

**Figure 5: Negative impact of alliances and cross-border mergers on airline operations**




## 3. THE POSSIBLE EVOLUTION OF MERGERS

The following group of questions pulled together the opinion of airlines in relation to the time evolution and the form mergers will take.

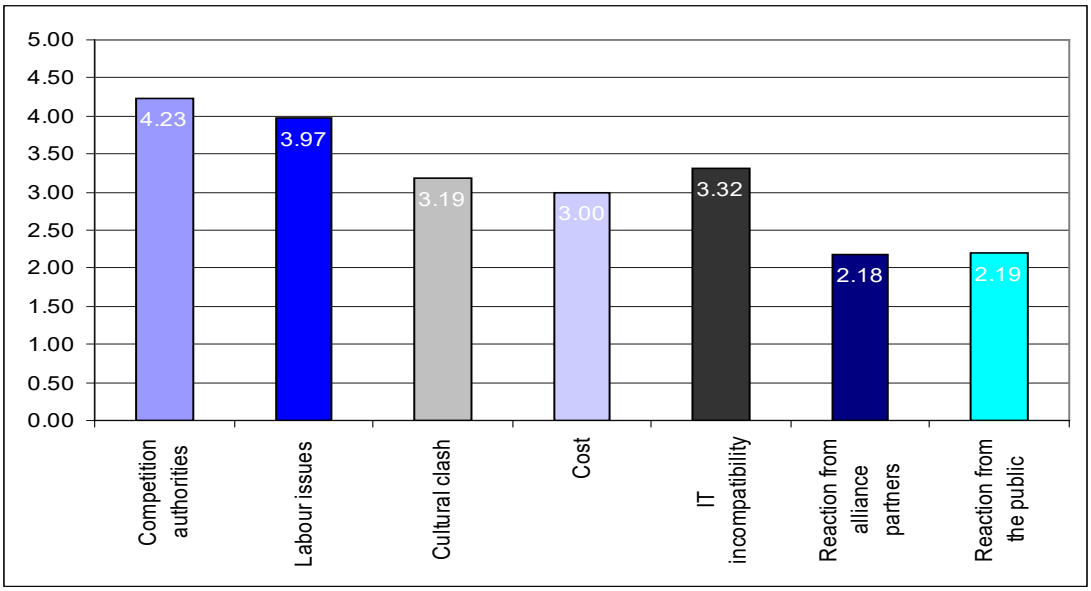
Most of the respondents (44%) consider that in the short-term (1-2 years, 44% of respondents) and medium term (3-5 years, 52%) new cross-border merger will be effected, and even cited as possible pairings those between British Airways/Iberia (20% of respondents), TAP/Varig, Lufthansa/Austrian, Singapore/Qantas and Air France/Alitalia with 10%.

Much of the literature on air transport has long claimed that if the clauses on national ownership were eased or lifted, this would remove obstacles to the consolidation needed in the industry. The respondents however, (53%) don't believe that regulation was and has been the reason that has prevented airlines from proceeding to mergers is regulation. The latest development with the Air France-KLM merger seems to confirm their views. In this case a new holding company was created and the two carriers continue separately their flight operations so as to circumvent traffic and flight rights restrictions. Competition and regulatory authorities were able to accept this complex governance structure and to interpret this merger pairing in a relaxed market-oriented way.

The overwhelming majority of the respondents believe (65%) that the open skies agreement between EU and US is a prerequisite for European and North American consolidation. Given the magnitude of intra-North America's traffic – 29.2% – of the world traffic flows based on IATA, 2004 – and of the intra-European – 23.3% – as well as the traffic between these two areas – 3.7% – (in total North American and European carriers control 56.1% of world passenger traffic) – in correlation with the fact that most major carriers operate in these areas, it is easily understood that such an agreement will be an important event in liberalizing the regulatory framework on a global scale. But whether this agreement will lead to cross-continent – that is, Europe- North America – mergers, remains doubtful given the US sensitivities in defense and national security issues (Fly America).

The most serious problems a merger initiative might face, according to the respondent airlines, would arise from the competition authorities (4.23) followed by labor issues (3.97). Mergers will certainly raise regulatory concern in terms of potential adverse impact on competition and consumers. Competition authorities will consider mergers on the case-by-case basis taking into account the current network structure of the prospective merger partners as well as the actual and potential competition on the routes involved. But another issue they will certainly consider and will bend their reaction to consolidation is whether an airline – whether flag carriers or not – can survive without being acquired.

**Figure 6: In which areas will there be reactions to mergers?**




*(1 = no serious problem, 5 = very serious problem)*

The form that future cross-border mergers will most probably take is the acquisition of one airline from the other as almost half of the respondents have stated (49%), just as it happened in the case of Air France/KLM and Lufthansa/Swiss. Experience has shown that merger attempts where a new entity was established, as in the case of Alitalia/KLM in the early 2000, failed mainly as a result of the difficulty in managing an entity in which neither of the airlines had effective control.

Even though a cross-border merger between smaller or medium sized airlines would give the merged partners the possibility to strengthen the position of the new entity in the market and inside the alliance, 70% of the respondent airlines have stated that cross-border mergers will have the form of a major airline acquiring a smaller one. It seems thus that it is the big players that pull the strings of the consolidation game. This does not mean however that the possibility of a "confederation" of smaller regional carriers should be excluded.

59% of the respondents believe that cross-border mergers would strengthen the position of the merged carrier inside the alliance but if this will affect the other airlines of the alliance depends on the case-by-case basis, that's why 28% mention that there will be no impact. Alliances are made up of a significant number of allies, thus any merger will not significantly alter the balance of power. After all, majors were and are the centres of gravity of all three alliances and it is them that will determine the course of both alliances and mergers.

Even though cross-border mergers so far, as those between Air France/KLM and Lufthansa/Swiss, have been effected between airlines that did not participate in the same alliance, 68% of the respondents have stated that future cross-borders will be effected between airlines belonging to the same alliances and such mergers will result in the strengthening of the merged entity within the alliance. It is certainly easier for two airlines that already co-operate on a bilateral level within the alliance to proceed to merger as they have built some level of trust and compatibility of operations. Furthermore, alliance membership seems to a large extent to have been fixed, thus no major realignments are expected.

As far as the question of multilateral cross-border mergers is concerned, answers diverge greatly as only 55% of the respondents dismiss such a possibility. Some of the respondents that have rejected this eventuality stated that the creation of a cross-border merger between two airlines is already too challenging of a task and quite difficult to materialize, which makes even more difficult to visualize the mergers of three carriers. Efforts within the framework of a tripartite attempt would be further hampered by the challenge of naming the new entity and by the concerns of competitions authorities and the increased cultural differences. But if indeed one of the future mergers is the one between Air France-KLM and Alitalia, this will be the first tripartite merger.

More than 2/3 of the airlines said that there will be cross-continent mergers. 75% of the airlines do not accept the statement that alliances are hard to govern, lack promised synergy benefits and have to a large extent failed.

From the analysis of the questions it results that alliances have failed to deliver the expected synergies only on the scale level. Airlines are proceeding to mergers not out of dissatisfaction from the performance of alliances but because they want to attain growth and have a better control over their operations.

**4. THE OPINION OF AIRLINES BY ALLIANCE GROUPING**

The three alliances agree that consolidation is slowly but surely gaining momentum. On the negative aspects of mergers, oneworld and Star Alliance believe that mergers have greater negative aspects compared to alliances in the category of branding dilution.

SkyTeam partners are the ones that seem ready to proceed to the next level of cooperation as 63% of them have stated that they would proceed to mergers had they not been prevented by regulation. On the contrary, the overwhelming majority of members of the other two alliances (71%) have stated that even without the obstacle of regulation they would not proceed to mergers.

The 55% and 50% respectively of Star Alliance and oneworld members believe that cross-border mergers will be in the form of the acquisition of the one airline from the other. SkyTeam carriers divide their views between "acquisition of the one airline from the other" (36%) and "the one airline will absorb the brand of the other". SkyTeam is the alliance in which a tripartite merger seems possible.

Oneworld airlines almost unanimously agree (86%) that future cross-border mergers will strengthen the position of the merged carrier in the alliance, and the majority of SkyTeam members seem to agree (56%). Half of Star Alliance carriers, on the other hand, believe that mergers will strengthen the position of the merged carrier in the alliance and the other half deems that mergers will have no impact on the division of power and weight within the alliance.

For oneworld and SkyTeam, the greatest eventual barriers against mergers will be raised by the competition authorities with 4.71 and 4.56 respectively followed by labour issues (4.00 and 3.78). Star Alliance carriers find that the most problems than a cross-border merger can face will come from the area of labor issues (4.07).

Opinions relating to the feasibility of cross-continent mergers diverge greatly with all oneworld carriers supporting that this can happen, Star Alliance members find it possible by a 64% response rate while SkyTeam carriers find it more unrealistic and only 44% think that such mergers are possible.

**5. THE OPINION OF AIRLINES BY AIRLINE SIZE**

The analysis of the responses shows that in two out of the three main categories of airline operation – economies of scale, economies of scope and economies of traffic density it is smaller carriers that support the superiority of mergers over alliances in the production of benefits.

As far as the negative aspects of mergers are concerned, it is the larger carriers that believe that mergers have more adverse effects than alliances.

It is quite interesting to mention that only 29% of the respondents representing the big airlines say that mergers will not strengthen the position of the merged entity within the alliance. An also interesting finding of the responses' analysis to the question "whether cross-border mergers will take place within alliances" is that the smaller the airline, the larger the "yes" percentage. (small 82%, medium 64% and big with 56%).

A very interesting result of the responses' analysis relates to the answers given to the statement: "Many academics claim that although airlines are unwilling to accept it alliances are hard to govern, lack promised synergy benefits, and have to a large extent failed". 60% of the small airlines agree with this statement, which shows that these airlines are not satisfied by the alliance performance.

**6. THE OPINION OF AIRLINES BY CONTINENT**

Airlines from Asia and Oceania believe that mergers have more disadvantages than alliances with the most serious ones occurring in the areas of lack of maneuvering and branding dilution. Carriers operating in these geographical areas are usually medium size airlines with a strong brand. Furthermore, they operate in an area that registers and will continue to register impressive traffic growth and they desire nimble corporate planning. Even if regulation was not an obstacle, airlines from Asia/Oceania state that they wouldn't proceed to mergers (71%); all of them also believe that a merger is a choice for the airline.

85% of European carriers believe that an open skies agreement between the US and EU is prerequisite for European and North American consolidation.

Finally, carriers from Asia/Oceania believe by 67% that alliances will stay as they are without any cross-continent mergers.

## 7. CONCLUSION

International alliances appear to be crystallizing around three major international groupings as these have expanded to include virtually all the major European and US airlines flying across the North Atlantic as well as an increasing number of airlines in other continents.

It has long been argued that strategic alliances are not permanent groupings and that the number of members and their influence on the relevant market can change quickly. But as alliances are deepening their scope and depth whether through mergers or through closer integration of the alliance cooperative systems, the lock-in effects increase, which means that the strategic flexibility of airlines will be reduced increasing high exit cost. This mean that in the future there will be fewer realignments but alliances will compete for additional members, especially from the regions with economic catch-up potential such as China and India.

The overall results of the questionnaire analysis clearly show that alliances and mergers will co-exist in the wider alliance structure, that mergers and alliances will evolve hand in hand. Consolidation is inevitable, especially on an intraregional level, but mergers will take place without destabilizing alliances, as mergers will proceed at a bilateral level while alliances will operate on a multilateral level. Alliances offer network and expansive growth, mergers promise efficiencies. Consolidation and integration will take different forms in different regions. It seems that airlines will try to balance the benefits of both perspectives, they will remain in an alliance and, if needed, they will seek mergers in a dyadic fashion.

Restrictive bilateral agreements are being gradually replaced by multilateral agreements between groups of countries, usually on a regional level. Most mergers will be between a major airline and a medium or small airline; therefore the balance of power within the alliance will not be significantly altered. The influence of the mergers on the alliance depends on the individual case in question, the size of the partners involved and their main area of operation. There will certainly be some merger activity within the next five years and more probably within EU but the early stage of consolidation does not allow predictions on how the future landscape will look like. It is probably going to be a long kind of process.

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