Airline Industry Consolidation—Myth and Reality

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Industry Consolidation—Moving to Fewer/Bigger Airlines?

Major Trend towards Fewer/Bigger Airlines?

- **Major trend only if explained by clear economic/financial drivers**
- **Isolated merger cases do not constitute a major trend**
- **NOT fixing specific airlines with hopelessly unprofitable capacity**

Today's presentation to address three questions:

- **1--Is consolidation happening now? is it inevitable?**
- **2--Why has consolidation suddenly become the industry's #1 topic?**
- **3--Would consolidation be good for industry growth? consumers?**

why discuss consolidation at a forecasting conference?

- **potential impact of "fewer/bigger airlines" on key drivers of growth**
  - Near Term>>Productivity
  - Medium Term>>Capital Allocation
  - Longer Term>>Dynamic Competition

Three key arguments for Industry Consolidation

① **Productivity (scale/scope economies):**

Fewer/Bigger Airlines would be more efficient

② **"Natural"/"intuitive"**

We have more airlines than we need;
All industries eventually consolidate;
recent observed US merger experience

③ **Cross-border breakthrough**

Airline Nationality restricts productivity/capital efficiency

Airlines should be treated same as soda

Merger track record is awful

Successful merger	Creates strong, lasting financial/competitive value justifying acquisition cost and risk

80's merger wave

last ten years

	SUCCESSFUL	BAD RESULTS/FAILURES
80's merger wave		80: Pan Am/National
		82: Texas Intl/Continental
	86: TWA/Ozark (STL hub)	87: Continental/PE/NY/FL
	86: Northwest/Republic (DTW/MSP hubs)	87: American/Aircal
	87: Southwest/Muse (restructuring)	87: Delta/Western
		87: Continental/Eastern
		88: USAir/PSA/Piedmont
last ten years	94: Southwest/Morris	00: American/Reno/TWA
		00: United/USAir
		00: Air Canada/Canadian

US Consolidation talk focusing on least promising mergers

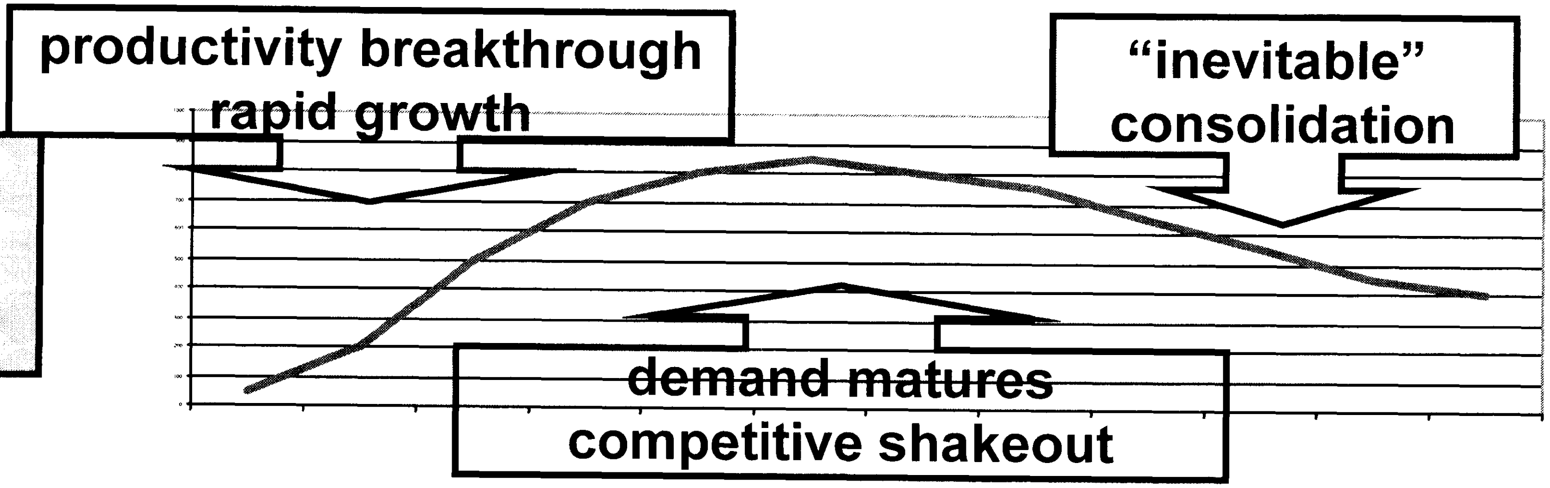
category	Economic drivers	US examples	Non-US	
Quasi-Restructuring	**Bankruptcy-type asset restructuring**	US-HP/DL WN-MC	LH-LX	**Not really mergers**
Hub Consolidation	**Fix historical regulatory distortions**	TW-OZ NW-RC	CX-KA AF-IT	**Obsolete category in US**
Cost Efficiencies/ End-to-end Network Synergies	**Savings from scale/scope economies**	US-PI AA-TW DL-WA	SR-SN KL-AZ	**Savings not large enough to offset costs, risks of merger**
Strongly anti-competitive	**Market stranglehold sustained by strong entry barriers**		BA-BR KL-AF	**Hasn't happened in US**

Hypothetical efficiency/synergy merger: **UA buys CO**

CO assets worth $4 bn today

--need $3-4bn in synergies to justify merger risk

"Inevitable Consolidation" argument doesn't apply

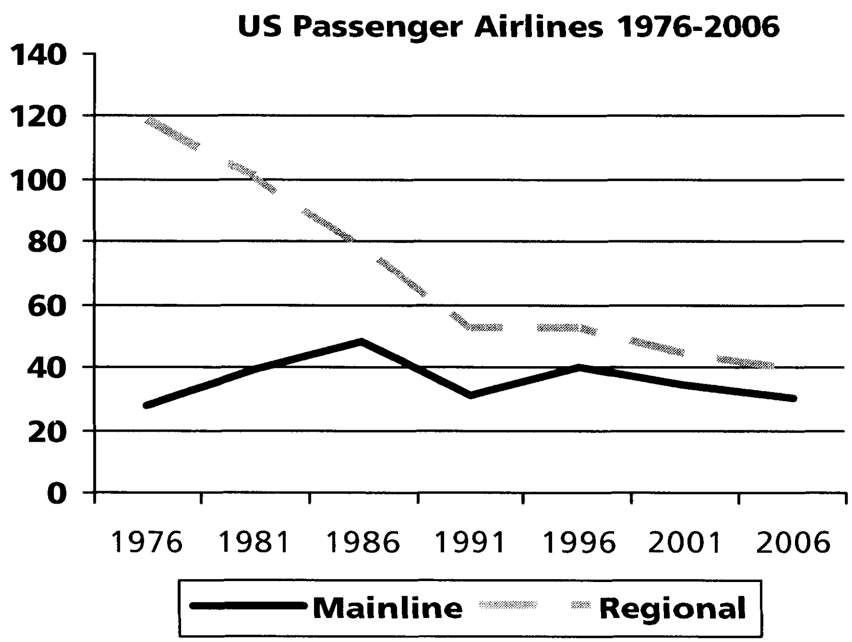


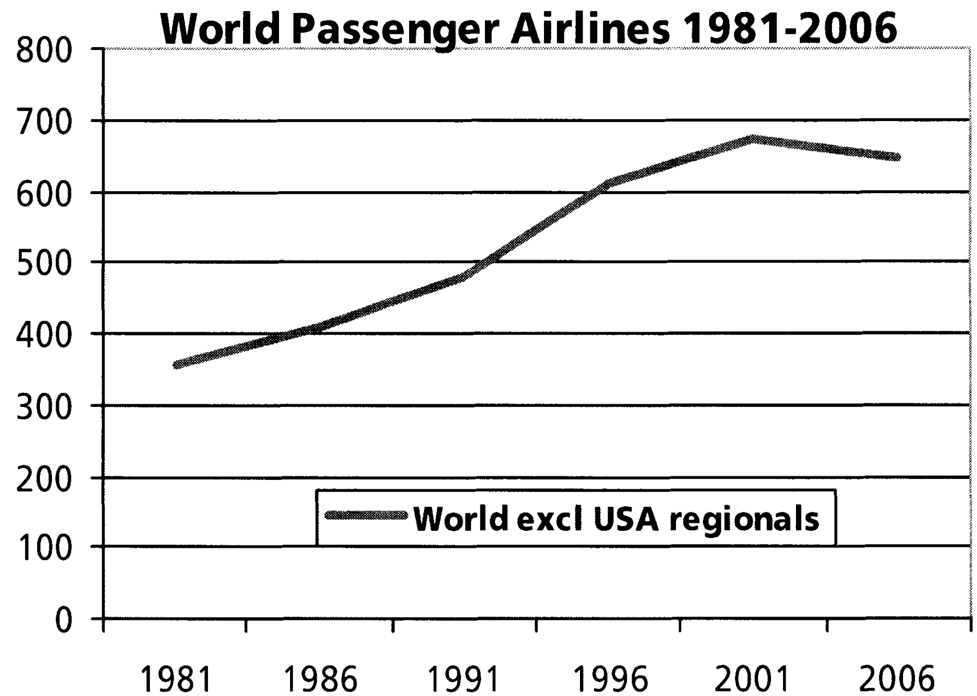
theory:
product
lifecycles

reality: airlines are not maturing/declining

- **Potential for productivity gains far from exhausted**
- **Longhaul/international markets especially vibrant**

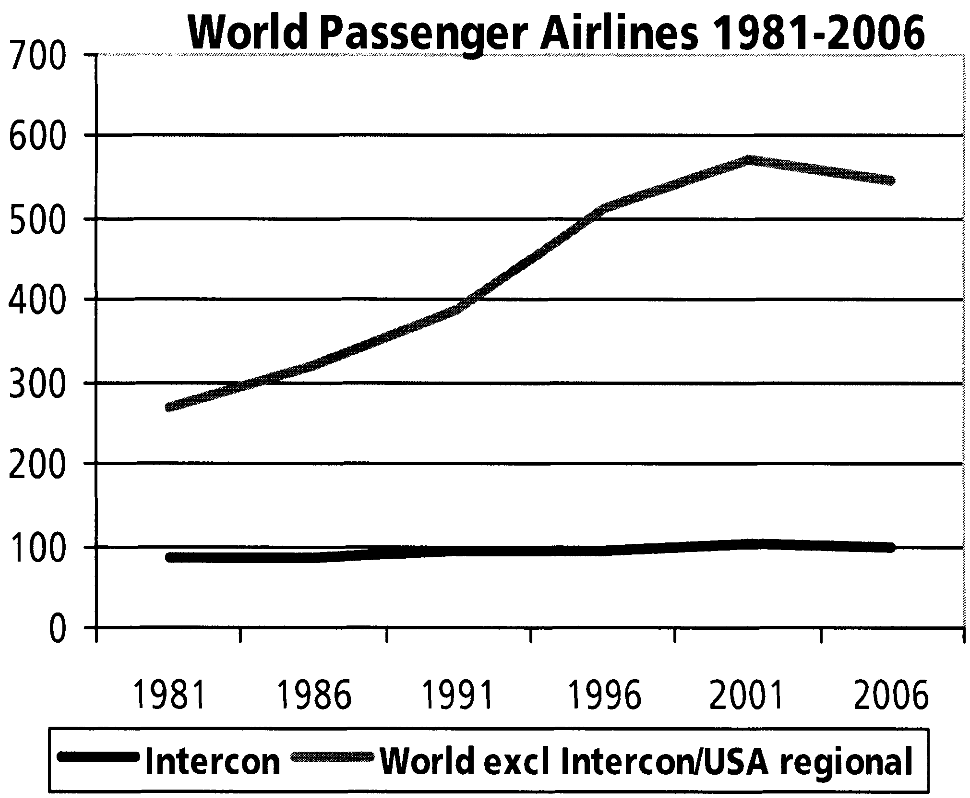
In a growing industry, mergers help <u>reduce</u> consolidation





- **Mergers due to "Dynamic churn", not consolidation —active entry/exit as capital shifts to more efficient uses**
  - **107 US mainline carriers, 77 gone, but overall numbers stable**
  - **409 European carriers, 203 gone, overall numbers increasing**
  - US Regionals only airline sector with significant consolidation

Two separate airline industries



Intercon airlines vs rest of industry

- **Huge barriers to entry/exit**
  - protected "national champions"
  - subsidies for weak/failing
- **Stagnant industry structure despite huge demand growth**
- **No "dynamic churn" to drive capital efficiency because of huge exit barriers**
  - **exit rates since 1981:**
    European airlines 50%
    USA Mainline 70%
    Intercon 20%

Three huge obstacles to real cross-border freedom

Entrenched Safety/Legal Systems

- **Regulators: safety/legal protections depend on worldwide system of "national" airlines**
  - Also consumer/supplier/labor protections, antitrust
  - 60 years of entrenched practices

Entrenched Political Obstacles

- **Politicians: support for "national champions" world-wide resistance to "foreign ownership"**
  - Just as unacceptable in US, EU, Australia as in more vulnerable/protectionist countries
  - Cross-border freedom meaningless if not worldwide

Entrenched Competitive Barriers

- **Intercon Airlines: Barriers to competitive entry much more important greater capital flexibility**
  - Worst of all worlds: Freedom to merge without meaningful market entry/exit freedoms

Is consolidation happening? inevitable?

- **Consolidation won't drive future industry growth**
  - No productivity gain to justify huge risks; threatens "dynamic churn"
  - Cross-border airpolitical revolution isn't happening anytime soon

- **Airlines are not maturing/declining**
  - Decades of vibrant industry growth without consolidation

- **Mergers can work but usually don't**
  - Mergers can avoid or entrench problems, delay needed restructuring
  - Transaction focus not always consistent with long-term value creation

- **Mergers irrelevant to the industry's real needs**
  - Consolidation not the solution for unprofitable/bankrupt carriers
  - Fewer barriers to reallocating capital (easier restructuring, market exit)
  - Reduced political influence over airline competition/investment decisions
  - Cross-border innovation--small/developing countries

Who is arguing that "consolidation is inevitable"?

Biggest Intercon airlines in biggest markets

- PR efforts of United, Air France, Lufthansa, IATA
- EU demands to own 49% of large US airlines

Agenda is **Intercon** consolidation>>anti-competitive

- stagnant sector, huge entry barriers, big government role, protected "national champions"
- Intercon market already fastest growing, strongly profitable

Arguments totally inappropriate to Intercon airlines

- No access to capital; can't make money; too small to compete
- Entry too easy, too many airlines
- EU-US cross-ownership would generate more new jobs than DL+CO combined, more incremental revenue than NW+WN combined

Intercon consolidation would threaten industry growth

Move to Cartel on the North Atlantic

Market concentration	1999	2006	2009(?)
# of Airlines with >1%	20	10	3
Top 3 Airlines Share --Total North Atlantic	59%	77%	97%
Top 2 Airlines Share --US-Continent Europe	45%	77%	92%

Agenda since 2002

- **Neutralize small competitors (US, AZ, OS, TP, LX)**
- **EU policy shift to favor collusion/concentration**
  - AF-KL merger; EU-US cross-ownership; greater Alliance integration
  - Increased concentration since 99 due to governments, not markets
- **PR push for new wave of mergers (UA-CO)**

Risks to efficiency, consumers

- **Protected profits distort competition with WN, B6, U2, FR**
- **Kills possibility of marketplace discipline**
- **Weakens future innovation, "dynamic churn"**