



ANALYST VIEWPOINT

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AIRLINE MERGER AND ACQUISITION (M&A) ACTIVITY: A NEW “SUPER-CYCLE” OR “OVER-EXUBERANCE”?

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At the last IATA AGM in June 2006 David Bonderman, the chairman of both the Texas Pacific Group (TPG) and Ryanair, expressed the view that it was time to sell airlines. However, since that time there has been an almost unprecedented focus on merger and acquisition activity in the airline industry, with a number of cases progressing beyond the “talking about it” phase. Furthermore, a notable and often common feature has been the presence of TPG; whether as part of the consortium bid for Qantas or being seen as a front runner for Iberia and as an interested party in the case of Alitalia. At the present time it remains to be seen which, if any, of the transactions will be completed and, over the longer term, the extent of the value that is realised and created.

The recent agreement between the US and EU on “open skies” is seen as a further catalyst to consolidation amongst European carriers. However, it is necessary to be realistic about the real extent of the change that has resulted from the deal. Route rights to areas other than between Europe and the US will still be determined by individual bilateral agreements and will need to be renegotiated in the case of any change in the nationality of ownership. Whilst this is not impossible it takes time. In addition, while consolidation of an industry and merger and acquisition are generally used interchangeably, exit is also a route for consolidation at an industry level.

Can M&A activity create shareholder value?

Despite the excitement and periodic hype it is necessary to question where the value may arise from M&A activity, both generally and specifically in the airline industry. Size alone has never been a sufficient condition for improved performance; indeed perhaps the question that should be asked is whether or not consolidation resulting from merger and acquisition will help to improve the inadequate returns faced by the airline industry? Although not wishing to prejudge, it is probably fairly safe to suggest that without other significant action this is unlikely. Even with such action there is no guarantee of success. Furthermore, the additional action necessary is neither costless nor will be it be achieved without considerable effort.

Another important issue is where and how the value in any transaction will show through. For the existing owners of an airline that may be a target (agreed or hostile) the issue is whether the offer on the table is worthwhile taking or not – particularly if it is cash. Does it represent a value beyond that which can be reached by trading alone (or fully reflects its strategic value) plus a premium for control? For the bidder’s shareholders the source and ability to realise perceived value will be determined on a case by case basis and clearly differs between whether the acquirer is an airline or a financial investor.

At the February 2007 Aircraft Finance Forum, held in Geneva, a couple of the questions posed in the electronic polling session sought answers on the benefits or otherwise of changes in ownership for airlines. Specifically views were sought on:

- Whether consolidation involving two or more airlines will produce increases in shareholder value; and
- Whether private equity funds investing in airlines will be able to generate “sufficient” returns within their required time periods.

In the case of consolidation involving airlines, 62% of the 550 or so delegates in Geneva thought that there would be an increase in shareholder value. However, in the case of the private equity funds, 72% thought that they would fail to generate “sufficient” returns within the “required” time period.

The options for and barriers against airline consolidation

Whilst for an airline “in-country” acquisition in reality only focuses on issues of value and management position, in Europe and some other parts of the world there are the regulatory issues that still need to be considered where route rights may be put at risk.

For an airline, the acquisition of another airline represents a strategic step and generally a move to strengthen its position, integrating the business where possible and removing duplication. However, as we have seen with Air France and KLM, although progress has been better than generally expected – perhaps in part a reflection of the conditioning of expectations – the reality is that the undertakings that were required to be given meant that there was never going to be a “big bang” approach to cost reduction, even before taking into account the managerial and financial ramifications of such an approach.

Whilst integration appears to be an issue of considerable importance for airline managers, consideration perhaps should be given to a portfolio management approach where a number of airlines are controlled by a single company – rather like an airline fund but where the difference is that the airlines are owned and controlled. At least at a theoretical level, the benefit to the shareholders of the acquiring airline would be that they now gained access to (hopefully) structural growth. But from an investor’s perspective where would the difference be from buying and owning a share in a multi-airline company and owning shares in a number of different airlines? The answer is very little, unless there was a management benefit which translated into shareholder value.

At the present time most regulatory regimes continue to provide constraints, precluding the acquisition of majority stakes by “non-nationals”. As such, it may require a partnership approach to mergers. In adopting such an approach, airlines would not be significantly different in their approach to that of private equity investors. However, a key issue is that this would involve the acquisition of minority stakes without control – not necessarily a good way to go forward.

Generating value through private equity investment

Where then does the potential benefit lie for the private equity investors? These investors have to produce additional value and then realise it through a process which requires a re-flotation or an onward sale at a later date. In broad terms, the opportunity lies in the following areas:

- Improved operating performance
- Improved financial structure
- Sale of non core activities or other assets

Of course an offer from a private equity fund may reflect a value far greater than could be achieved by trading alone and a way for shareholders to “cash in”.

The threat of an unwanted bid could also act as a sufficient stimulus for pre-emptive action by current managements to improve the performance of the business generally; removing any underperforming activities; realising value from any non-core assets or activities and developing a more efficient financial structure. Unfortunately, few of these can be achieved rapidly and indeed in terms of improving the financial performance the need will be for labour to share the same concerns. Until a bid emerges, the “better the devil you know” approach is unlikely to succeed.

The risk of over-exuberance

No matter what the background might be, it is important to recall the difference between value and price. It is clearly possible to apply a wide range of methodologies to determine a value in isolation for a business or assets. However, the extent to which the value is reflected in the actual price paid clearly depends upon a number of factors. These

may include, on one side, the reasonableness of the underlying assumptions made as regards value and, on the other, the prevailing conditions at the time of disposal and the degree of competitive tension.

Despite the view expressed by some observers during 2006 that aviation was in some type of “super-cycle” there is little evidence to support this contention. Indeed, in response to some additional questions that were posed at the Geneva Forum, views were expressed that:

- aircraft deliveries are expected to peak in 2010;
- airline profits are expected to peak in 2008; and
- that the market had over-ordered aircraft.

Add to this the perceived threat to the industry from “geo-political” events and some inevitable economic slowdown; it would appear that we are somewhat close to the top of the market – a period that has traditionally been associated with high values placed on and high prices paid for acquisitions.

Deal momentum and the fear that if another bidder is successful the target “may be gone for ever” are not sufficient reasons for the price to diverge from the real and realisable value of any transaction although they may set up some dangerous bandwagon effects. History is littered with very many examples, across a wide range of sectors, where the expected synergies or realisable benefits failed to materialise, with the consequence that value has been destroyed rather than enhanced. After all, size alone is no guarantee of success or value.

The aviation industry is never dull. It is clear that merger and acquisition fever has brought an added dimension. However, while it is said that “fortune favours the brave” it is also important to remember the adage that “act in haste and repent at leisure”.