

# United + Continental is good news for all stakeholders: More mergers are needed

*Is American and US Airways next?*

*The following is a white paper by three industry experts making the case that the network airlines that provide essential access to global markets are in danger of slowly liquidating if they are not allowed to merge. Mergers provide a market-driven restructuring solution that effectively allows the network airlines to compete with the emerging low-cost carrier business model.*

Paul Mifsud / Carlos Bonilla / Vaughn Cordle, CFA

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## **The U.S. airline industry can only support three large network airlines.**

The announcement of a United-Continental Airlines merger renews interest in the legal, financial and political issues surrounding consolidation in the U.S. airline industry. Perspectives on these issues among the many industry stakeholders—consumers, communities, investors, suppliers, labor, competitors and politicians—vary, but it is clear that the corporate and governmental policies applied to these subjects affect not only these stakeholders, but also the national economy and the trillion-dollar travel and tourism industry that relies so heavily on a healthy, reliable air transportation network.

The purpose of this white paper is to make the case for market restructuring of the U.S. legacy airlines and the industry in general through consolidation. In the U.S., such consolidation provides an important network foundation that—with the right corporate, labor and political leadership—sets the path to sustained growth and U.S. leadership in the development of the emerging 21st-century global air transport networks. Without this leadership and without further consolidation, we expect there will be at least one, and perhaps two, more failures among the network airlines, as well as several low-cost-airline failures.

It is important to recognize that the airline industry is composed of a variety of business models that satisfy distinctly different, though often overlapping, transportation needs. For simplicity's sake we distinguish among network, low-cost and regional carriers.

American Airlines, United Airlines, Delta Air Lines, Continental and US Airways are the major U.S. network airlines. Using a broad mix of aircraft types, they gather passengers from small and large airports, domestic and international, and distribute passengers through hubs strategically located around the country. This model enables network airlines to accept passenger flows from other carriers' networks, so commercial relationships with regional carriers and international network carriers efficiently extend the network carriers' reach. The network airline model provides a vast number of communities, their business travelers, and visitors with global access to the world's markets. However, these network efficiencies come at the price: Complexity, legacy labor policies, outdated infrastructures, and poorly considered government policies (domestic and foreign) have resulted in lost efficiencies and higher costs for the network carriers.

Southwest, Jet Blue, Air Tran, Frontier and Spirit are examples of low-cost carriers (LCCs). The low-cost model also operates from hubs (called "focus cities" by some), but LCCs tend to operate limited types of aircraft, to feature point-to-point services, and to operate only between high-density domestic and cross-border airport markets. Simplicity, newer fleets, and a younger labor force that began work in a low-cost environment, as well as quick turnaround times for their aircraft, provide efficiencies that result in low fares. However, this model does not lend itself to serving low-density or small communities. Moreover, the extension of this model internationally, beyond a few cross-border routes with Canada, Mexico, and a

few Latin American destinations, has yet to be proven, although Southwest's large domestic market share makes it the most likely candidate to initiate long-haul international operations. We expect it to do so within the next five years.

Regional airlines such as Sky West, ExpressJet, Pinnacle, and Republic (the last a hybrid airline that also operates Frontier as a branded business) are "fixed-fee for departure" airlines that use a modified LCC model and operate smaller aircraft suitable for low-density airports. They connect at the hubs of network partner airlines pursuant to contract conditions that are subject to the often strict limitations of the scope clauses in the collective bargaining agreements of the network carriers. These carriers are specifically structured to link the smallest communities that receive air service with the network hubs.

### **Evaluating Airline Mergers**

All that said, in any discussion involving airline consolidation, there are a number of issues that should be put into perspective:

- Department of Justice policies related to their analysis of market concentration, product definition and potential market power in the air transport industry were first developed in the years just after deregulation in 1978 and have not been modified since. Simply stated, the policies are dated and stuck in the past.
- The years immediately following deregulation saw the proliferation of U.S. network carriers, most of which derived over 80% of their revenues from domestic air transportation. Combined, they provided a similar proportion of all U.S. domestic available seat miles (ASMs) and Revenue Passenger Miles (RPMs)
- Today, there are only five major U.S. network carriers and 28 LCC and regional airlines in the U.S., so there has been a considerable alteration in the composition of domestic competition
- The U.S. network carriers' share of the domestic market (excluding ASMs flown by regional affiliates) has been shrinking annually. In 2009, Southwest, the largest LCC, continuing its faster *relative* growth trends, provided 14.6% of total U.S. ASMs, while Delta provided 16.1% after the Northwest merger in late 2008 [Figure 1].
- United and Continental together provided 17.7% of the domestic ASMs in 2009. However, we ultimately expect to see a 5-10% reduction in combined capacity post-merger, which will reduce their market share and improve efficiencies. This outcome results because one of the major purposes of airline mergers is making routes more rational. For example, the pre-merger domestic shares of DL and NW, were 10.1% and 6.3%, respectively in 2008, but combined they had a 16.1% share in 2009.
- Given what we consider an appropriate amount of domestic ASMs produced post-merger, a combination between American and US Airways would be approximately 19.6%, which is somewhat larger than United/Continental, Delta/Northwest, and Southwest.

Figure 1:

2009 Market Share - ASMs and RPMs			
<i>in percentage terms</i>			
		ASMs	RPMs
1	United + Continental	17.7	18.4
2	Delta + Northwest	16.1	16.8
3	Southwest	14.6	13.7
4	American	13.9	14.1
5	US Airways	7.9	8.1
6	JetBlue	4.3	4.2
7	AirTran	3.4	3.4
8	Alaska	3.2	3.1
9	Frontier	1.5	1.5
10	Hawaiian	1.3	1.4
11	Virgin America	1.0	1.0
12	Spirit	0.9	0.9
13	Allegiant	0.7	0.8
	Regionals & Others	13.5	12.6
	American + US Airways	21.8	22.2

Our analysis of the trends over the last decade suggests that, without a new strategic direction and significant changes in the industry's structure, American Airlines and US Airways as stand-alone entities will continue on the slow liquidation path to failure. United and Continental have already reached that decision. Corporate, labor and government policies that ignore these trends risk reshaping the competitive landscape and America's access to the global air transport network far more adversely for stakeholders than the current consolidation trend that naturally led to mergers between UA, CO, DL, and NW.

### **Bad industry fundamentals: Excess Capacity and The prisoner's dilemma**

In game theory terms, the industry's problem represents the classic "prisoner's dilemma" because firm value, airline economics and passenger preferences provide strong incentives for each airline to generate excess capacity in order to gain to gain market share and lower relative costs. These incentives are so great that the ability of the individual airline to profitably maintain seat production levels that optimally balance supply/demand is severely limited. The result is, collectively, the entire industry is laden with excess capacity. Excess capacity is at the heart of the industry's inability to earn its cost of capital.<sup>1</sup>

This is a confusing issue since when one looks at today's uncomfortably high passenger load factors (planes are on average about 80% full, which means many flights are completely full), the concept of excess capacity doesn't ring true. When both price and supply elasticity are thoroughly examined, however, the airlines' excess capacity can be measured and defined in quantitative terms. We calculated the economic returns (in Economic Value Added terms) for the industry during each business cycle and for each airline. We found that for the decade ending in 2009, the industry produced an average of 6.4% excess capacity, and that this drove the \$69 billion in net losses (in 2009 \$), equivalent to a negative 5.5% of revenue. Seen from the consumer perspective, the industry underpriced its product by 10.5 % over the 10 years ending 2009. However, it was the six network airlines that lost the most money during the

<sup>1</sup> Astute observers will note that this type of response is exactly what competitive markets are supposed to accomplish. We will simply note that the airline industry must increase capacity not by single units but in plane-load increments flown 10-12 hours a day, 365 days a year. The product is highly perishable and the revenue associated with putting a passenger in a seat far exceeds the marginal cost for that passenger (which is essentially \$0). These and other factors go a long way towards explaining an industry which has lost \$69b in the last decade.

decade: \$70.4 billion in reported losses which represented a 12.6% revenue shortfall for the decade ending 2009.

The only way the industry could have priced the product at its true economic cost was to reduce the excess capacity. Of course, this was not possible because for every airline the growth imperative led it to seek higher market share in order to lower average unit costs and expand market valuation multiples. Growth results in lower average costs because new employees are brought in at first-year pay and maintenance costs are lower when equipment is new. "Grow in order to lower relative costs" is a rational strategy for management at the individual-airline level but results in destructive price competition at the industry level.

So the fundamental industry problem is that what appears to be perfectly rational for the individual airline is irrational at the industry level because it negatively impacts industry structure and market concentration in such a way that the individual airline cannot earn its cost of capital. Hence, bad industry fundamentals result in an industry unable to attract and maintain shareholder support.

These bad industry fundamentals will not change without consolidation one way or another. For Continental and United, the best option is to merge because the alternative is to fail, and the same holds true for US and AA. Failure is not a good option for labor and other stakeholders, especially for the shareholders and for small communities, which can only be served if there are profitable and large network airlines. Network airlines must be able to afford to fly the thinly populated short haul flights utilizing small regional jets if small communities are to continue to receive air transportation service. The low-cost LCC airline model is not designed to service these small communities.

**Our analysis suggests that the U.S. market can support a maximum of only three major network carriers.**

Although we are forecasting profits for the U.S. majors in 2010 and 2011, these projected levels of earnings do not address poor balance-sheet and earnings fundamentals such as inadequate retained earnings, required capital investment, and growth opportunities. Without improvement in the industry fundamentals, the airlines will remain unable to satisfy consumer expectations and investor and labor requirements.

Our financial models indicate that industry revenue must increase by 15-20% to offset over \$20 billion in higher government fees, security costs, fuel and labor costs that are looming over the industry. Although charging higher fares and ancillary fees would reduce demand and result in 10-12% of excess capacity that should be removed, this is not likely to happen without additional mergers. If the industry is not allowed to consolidate in the most rational manner, the result will be a continuation of the slow liquidation and the inevitable failure of at least one of the remaining network airlines in need of restructuring (assuming the United Continental merger is approved on favorable terms). A likely outcome would be an eventual American bankruptcy and outright liquidation of US Airways. It should be noted that Continental, US Airways have already filed bankruptcy twice before and United once.

While aviation is traditionally a cyclical industry, the current business cycle is different because the large network airlines have never been so weak or so over-leveraged. Capital expenditures have been inadequate for too long. Even if consolidation proceeds, the remaining legacy airlines must retain many years of earnings before they have a healthy capital structure.

We estimate that network airlines have a \$48 billion [book] equity deficit on their balance sheets. Growth and proper investment in equipment and human capital is not possible until this deficit has been addressed via retained earnings. And adequate retained earnings are not possible unless the market structure changes to increase market concentration. Succinctly stated, the industry has too many airlines and this does not allow the profitability required to properly invest in the business *and* satisfy key stakeholders.

Without consolidation, five separate weakened network carriers will be unlikely to accommodate the higher industry costs we project by 2014:

- \$6.5 billion more in fuel costs in 2010 over 2009, and an additional \$2 billion in 2011
- \$2 billion in higher airport passenger facility charges
- \$2.7 billion in additional annual security costs by 2014
- \$4-6 billion in higher labor costs.
- \$3.5-\$7 billion in aircraft equipment for NextGen, the FAA's next generation air traffic control system

The network airlines cannot absorb these costs by borrowing, since none of them are creditworthy; they all carry below-investment-grade credit ratings. Near term profitability notwithstanding, they are not capable of generating profits over a full business cycle. In short, in their current form several of the network airlines may not survive another economic downturn given their large negative tangible equity.

Consolidation in the industry -- the planned merger between United and Continental and the merger we advocate between American and US Airways -- provides one path that can create real value for the stakeholders of these two airlines and the industry. In our judgment, it is the best option as it produces cost and revenue synergies that would not exist otherwise. The improved economics allow the airline to properly invest in its human and physical capital, and improve returns on capital. With the merger of United and Continental, the odds of liquidation and/or bankruptcy for US Airways and American increase over time because it will be too difficult, if not impossible, for them to remain viable as stand-alone businesses. Why? Neither airline will have the network size, and resultant economies, to compete profitably in the domestic and international markets.

Conversely, the loss of US Airways through liquidation provides the same result as the two mergers we argue for—three network carriers. But without the increased global and domestic reach provided by merging with another network carrier, American would be a weak competitor against the United/Continental and Delta/Northwest alliances. An American -- US Airways combination would gain from network [so called scope economies] efficiencies and the elimination of redundant and overlapping functions. Moreover, their customers would benefit from a larger and a more rationalized domestic operation. In addition, an American/US Airways merger should remove even more uneconomic capacity than the United/Continental combination.

Airline liquidations and bankruptcies are chaotic events, and they do not always result in desirable outcomes like capacity reduction or more favorable market conditions. Mergers, on the other hand, allow effective managers to control the restructuring of their networks and fleets in a way that works best against the market, industry, and economic forces that negatively impact company earnings and growth. Currently AMR management appears not to be interested in a merger with US Airways. Cultural and labor issues are significant obstacles. However, given a status quo scenario that could lead to a bankruptcy a merger may remain the best option for both shareholders and labor. Even the consumer benefits when a bankruptcy is avoided.

### **It's the network, stupid.**

Removing costs and increasing an airline's scope with the least amount of capital is the path to financial success. Given the downward spiral in market share for network airlines that has occurred over the last decade, a powerful business and valuation case can be made that the three network combinations that would result could reduce costs in the \$3 billion range annually. On the revenue side, the economies of scope (i.e., the network effect) would also increase revenue and cash flows by approximately \$3 billion. The net effect of the mergers is approximately \$6 billion in additional value created, or roughly \$2 billion per combination. Revenue and cost synergies could result in *lower* costs for the consumer than what would be the case otherwise, when all else is held constant. And, it's the only way the airlines can afford to satisfy labor.

Network efficiencies and the resulting lower costs are a function of the degree to which the various markets are integrated into the network. Optimizing efficiency through integration will result in a business that has the *chance* to be worthy of longer-term investment, and one that can better satisfy both consumers and labor.

Domestically, the regional carriers provide access to markets too small to support full service by network airlines, and internationally, foreign networks provide global access. Domestic integration with regional networks is a function of, among other things, the kind of effective labor-management relations that lead to unit costs that make service by small jets viable. Internationally, while cooperation among larger domestic carriers is somewhat circumscribed by U.S. antitrust laws, the U.S. Department of Transportation (over the objections of the Department of Justice) has encouraged American and certain foreign airlines to increase their network efficiencies through antitrust immunity, which led to the development and growth of three global branded alliances – Star, Skyteam and oneworld. Although these alliances are still in the process of developing, one strategic element is clear: Each participating network carrier is valued in terms of its access to its national home markets. Broad market access is also highly valued by the network airlines' most important commercial customers.

For both American (oneworld) and US Airways (Star), this means that the United/Continental (Star) and Delta/Northwest (Skyteam) combinations can provide their global branded alliance partners and customers richer, more integrated access to the U.S. market. But an American/US Airways merger would enable AA to remain competitive within the U.S. market (and with a reshuffling of alliance partners) actually enhance competition

Internationally, U.S. negotiators and DOT policy have positioned the major U.S. carriers at the center of the developing global networks. European, Chinese and other Pacific governments and their carriers seem content for the moment to let the U.S. and its carriers take the lead. Therefore, the big U.S. policy question is whether the DOJ will focus its merger review on a few narrow domestic markets (as it has in the past) or consider the national interest by encouraging a strong, dynamic global aviation network.

If it does the latter, then our analysis shows that the United/Continental merger will result in a more extensive national network that ultimately utilizes about 10% less capacity than the pre-merger airlines. Similarly, an AA/US merger will result in a national network with more scope utilizing, 10-15% less capacity than the pre-merger airlines. It is efficiencies such as these that start the industry back on track to sustainable profitability. The net impact on the domestic seat capacity will be only 2-5% if both mergers occur and our assumptions about capacity reductions are correct.

### **Business, labor and government leadership is required.**

Mergers are not a panacea. They involve risk, and without the right leadership from management, labor and government, they can perform poorly and fail miserably. The success or failure of any merger depends on the details of the deal, the ability to execute profitability, and the quality of labor and management cooperation. The Delta/Northwest merger appears to have been implemented with unprecedented levels of labor cooperation from the pivotal pilots' groups, and reports are circulating that UA and CO pilots also exhibited insightful levels of cooperation.

The same cannot be said for either AA or US at this juncture. However, the structural dynamics we highlight are well recognized throughout the industry, so the announcement of a United/Continental deal may well provide a fresh perspective to the labor-management positions of both US Airways and American.

### **Airlines cannot satisfy labor with the current industry structure.**

Labor at the network carriers have lost, on average, 33% of their legacy pay and benefits while undertaking a heavier workload, and the resulting employee discontent in the service-oriented airline

industry has contributed to public hostility. Unless a path to renewed growth can be found, employee disenchantment—and public hostility—will continue to grow.

We forecast the network carriers will shrink to 53% of the total domestic capacity by the end of 2010, after the United/Continental combination versus 80% 10 years ago and 94% in 1992 [Figure 2]. If network consolidation proceeds as we believe it should, the three rationalized networks will lower network capacity and costs considerably and facilitate the profitability required to restore labor compensation to level acceptable to labor. Moreover, if the secular trend of faster relative growth in LCC capacity continues, and the three network airlines combine as we suggest, the remaining three network airlines could eventually provide as little as 40% of the total domestic ASMs. The result is a level of market concentration that protects the consumer from anti-consumer pricing and encourages an increase in lower-cost competition.

Figure 2:

### Market Share in Available Seat Miles (ASMs)

*Percentage of total domestic-only ASMs*

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	% chg
Network Airlines	81%	80%	78%	75%	69%	66%	64%	61%	58%	57%	56%	-33%
Southwest	8%	8%	10%	10%	11%	11%	11%	13%	13%	14%	15%	88%
Other	11%	12%	13%	14%	20%	23%	25%	26%	28%	29%	30%	173%

The resulting domestic market will be divided among the low-cost and regional carriers, on one hand, and the network carriers on the other. Southwest continues to be a dominant provider of ASMs but, viewed in global terms, this domestic configuration does not risk giving any player unreasonable market power. Airlines will be able to share more with labor and make much-needed capital investments if industry consolidation results in system-wide network rationalization.

### Where do we go from here?

The network carriers provide an essential service to the national economy as their networks link small, medium, large and international markets around the globe. Given the current condition of the industry, the network airlines can survive over the long run only if the government allows consolidation in the form of mergers.

Network consolidation and rationalization can allow the industry to be viable over a full business cycle. This is a valid measure of minimum profitability that we believe is the best way to assess the industry's health and viability. It is our contention that the domestic market as a whole along with its global network structure is the proper context for a healthy debate about the benefits and risks of network airline mergers and consolidation. Whether viewed in national or global terms there will remain a wide variety of competitive airlines providing consumers with many air travel choices.

It takes rational government policies and sound management and labor leadership to arrive at a public policy that can advance, rather than hinder, the restructuring this industry needs. Absent a change in industry structure, the network airlines will continue to shrink. As a result, communities around the nation will be increasingly isolated from global markets, and capital markets and labor will continue to withdraw their support in ways that ultimately harm the consumers of air travel and the broader economy. It is for this reason we believe that further consolidation is needed and that mergers between United and Continental as well as between America and US Airways represent the best option for the stakeholders of these airlines.

The management of these airlines have made the right decision to combine operations in a way that benefits their employees, shareholders, and the communities and air travelers. In the final analysis, we believe that mergers represent the best outcome for an industry in desperate need of consolidation.

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**Paul Mifsud**, an airline political strategist and government affairs expert in private practice, focuses on aviation alliances and metal neutral joint ventures. Formerly Vice President, Government & Legal Affairs, USA, for KLM Royal Dutch Airlines, he was named 2008 Transportation Lawyer of the Year by the Federal Bar Association and received the Order of Oranj-Nassau (Officer) on behalf of the Queen of the Netherlands. [pmifsud@earthlink.net](mailto:pmifsud@earthlink.net)

**Vaughn Cordle, CFA** is Managing Partner and Chief Analyst at AirlineForecasts, LLC and serves as an airline analyst to various institutional investors and money management firms. Cordle has over 25 years of experience in the airline industry and is a former B777 Captain for United Airlines. He has attended numerous executive education programs at Kellogg, Wharton, and other business schools and is a Principal of The Aviation Group, a Gerson Lehrman Group Leader, and a member of the New York Society of Security Analysts. [vaughn@airlineforecasts.com](mailto:vaughn@airlineforecasts.com)

**Carlos E. Bonilla** is Managing Partner and Chief Economist at AirlineForecasts, LLC. A former Sr. Vice President with Washington Group, Bonilla has represented clients before the U.S. Congress and other parts of the Federal government. From 2001 to 2003 he served on the White House's National Economic Council as Special Assistant to the President for Economic Policy, where he held the aviation and labor portfolios and was part of the tax policy team. Prior to that he served as Senior Economist for the U.S. Congress House Budget Committee and as tax policy adviser for the chairman. Bonilla is on the Board of Directors of Mesa Air Group serves on its Audit Committee. [carloso@airlineforecasts.com](mailto:carloso@airlineforecasts.com)