

## **The Logic behind a UAL bid for US Airways (plan B) was to bring CAL to the table (plan A)**

United's Tilton's plan A has always been a merger with CAL. It simply took plan B, or the US merger talks to make plan A happen.

- The # 1 reason UAL/CAL is the best match up is that CAL creates much more value for the shareholders post-merger than a US/UAL deal. The other reasons are that labor will support it and that the JVs in the Atlantic and Pacific are merger-like combinations that naturally lead to a full merger of the domestic market to realize the full benefits of a combination.
- If CAL had not come to the table, US would have made a great match up with UAL given the JVs with CAL. The so called three way match up.
- US/UAL worked because the domestic combination would have taken excess capacity out of the system and the cost and revenue synergies would have been at least \$1.5 billion. The combination of higher market concentration, which enhances pricing power for all airlines, and the synergies, provided a two-punch benefit for the new and much larger UAL post-merger.
- However, by my estimate CAL/UAL produces \$2.2 billion in synergies and the post-merger [net] gain in market value will be almost twice that of a US/CAL combination.
- Tilton's real strategy - plan A comes together - worked because he would have executed on plan B and merged with US. In other words, CAL came back to the table because management believed that UAL was indeed going to merge with US, which of course was true if CAL did not re-engage in talks.

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## **The Logic behind a UAL Bid for US Airways**

*Why conventional wisdom may be wrong*

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There are different ways to view a potential merger of UAL with US or CAL, and it could be that the conventional wisdom is simply wrong in terms of the following critical assumptions:

- US or CAL management would displace UAL management in a merger

- US Airways is a basket case and would not work with UAL
- A merger with UAL will fail because most airline mergers are unsuccessful
- Tilton leaves after a merger or perhaps stays as Chairman of the Board

All of these airlines are basket cases. They continue to shrink vis-à-vis the LCCs, and their only salvation will come from their ability to fully participate in a branded global alliance, such as *Star*, *Skyteam* or *oneworld*. The successful U.S. legacy airline must have a national market – access to and provide access - to all the national market in the US and link those markets to a global network.

Historically, major US network carriers developed their strengths in regions, but none were truly national. When viewed in this context, the value created by a US and UAL merger becomes even more evident.

From a network perspective US is a much better fit than most people seem to realize. Given the large NY-LHR-EU origin and destination markets, it may be more commercially attractive to feed connecting passengers behind New York over Philadelphia and Boston rather than bringing them into congested New York airport.

Then, Charlotte flanks Delta at ATL. Also the addition of US would empower a Star move on oneworld's strong hold in MIA. With UAL and US, Star would end up with a balanced and strong US carrier with national reach. It is strong in the South west and West coast as well as on the East Coast. The merged airline would be able to expand further in the southern US as well as South America. US has developed a domestic low cost network model that can thrive with UAL's international feed requirements.

Airlines that do not have the ability to participate fully in an more integrated and connected national and global network will not succeed and it should be obvious to Doug Parker and team that the airline cannot survive without a merger partner like UAL.

### **UAL is likely the deal maker**

Perhaps it is UAL that makes a bid for US to capture the value created by a merger. And perhaps Tilton doesn't buy into the argument that CAL or US management is "superior" and will run the post-merger company. In other words, Tilton and team may want to manage the newly merged company and will not want US or CAL to benefit from the new value (cost and revenue synergies) that could be divvied up among UAL's stakeholders.

It's likely that Tilton and team have calculated the opportunity-costs of not being the deal maker and managers of a much larger airline with much improved economics.

Furthermore, a UAL bid for US would encourage CAL to reconsider a merger with UAL, which, in my opinion, has a large opportunity-cost in not participating in a merger. UAL wins with a US merger, and it wins even more if CAL decides to work with UAL or even makes a bid for UAL to preempt a linkup between US and UAL. Indeed, UAL shareholders would benefit if a bidding war ensues.

A UAL/CAL merger creates almost twice the post-merger value [up-and-above the current sum of the independent airline values] than a UAL/US merger. In my estimation, UAL could raise the capital required to make a bid for US, even when a control premium is involved and after higher labor costs are considered.

I believe that Wall Street will support a US bid, or a merger between UAL and US, and the merger could win DOJ/DOT approval, if structured properly. Structuring the deal properly includes addressing at least 15 city pairs, in addition to Washington DC, that have too much overlapping concentration.

Washington has little support for mergers because they are viewed as anti-consumer, since the industry's structure changes when two airlines merge and market concentration and pricing power increase.

All airlines will benefit as the industry naturally consolidates after \$70 billion in losses (-5.7% of revenue) over the last decade. Nevertheless, the increase in market concentration post-merger will still be too low for anti-consumer pricing and should not be a concern for politicians like Oberstar and the DOJ. I would expect congressional show-trial like hearings on any merger that could be perceived as anti-consumer. It's not anti-consumer when the industry must consolidate to earn its cost of capital and more importantly, to satisfy all stakeholders, not just shareholders. In my estimation, market concentration after another merger will not increase pricing power to a level that is considered anti-consumer.

Labor unions would be wise to support a UAL merger because to not do so risks even more high-paying union job losses than what has already occurred over the last decade as the big network airlines have ceded market share in a long war of attrition.

It will be extremely difficult for labor to extract higher compensation from airlines that are simply not viable as stand-alone businesses, especially in an industry that has too little market concentration and no pricing power. US and UAL labor have the most to lose if political forces gather enough force to kill any potential combination that will benefit the industry and labor. Moreover, consumers benefit from an industry that can afford to properly invest in itself and provide the level of service that consumers require. Demoralized and stressed out employees, working for impoverished, penny-pinching and nickel-and-diming airlines do not make for enjoyable consumer traveling experiences.

### **Incentives to merge: Why a deal can and should be consummated**

A merged airline only needs one set of executives and one set will have to be bought off with an attractive compensation package. The post-merger value of the airline will determine whether or not the surviving management team can benefit financially from a merger. Management should receive a large enough stake in the enterprise to align their interests with shareholders. A 5% stake is an appropriate stake for management and should do the trick, with perhaps 1% for the CEO.

If my base-case estimate is correct, a newly merged US--UAL could be worth at least \$9 billion post-merger, once cost and revenue synergies are fully realized. This is \$2.8 billion over and above the sum of the two airlines' market value today. Therefore, a 5% stake for management could be worth \$450 million. This is in addition to other forms of compensation and incentives. This 'pay-off' would not be available if the companies do not merge. Moreover, given large cost increases that are already in the pipeline, I would argue that current airline values are more than fully valued. In other words, equity compensation in the form of stock options will not provide the incentive boost that management requires to stay properly focused and engaged in terms of creating value.

Labor can moan and groan all they want about "greedy" management, but this type of equity compensation is standard and required by shareholders who must be the dominate stakeholder if the enterprise is to survive and thrive in a capitalist market economy. Labor unions and Team Obama may have a different idea about the type of system we should have, but this doesn't change the economics of business and the returns required to attract and maintain capital. Without adequate profitability, the enterprise is simply not viable.

The newly created equity post-merger is a form of currency that can also be used to buy labor's support for the deal, which will be required to preempt political

pressure that will build in an attempt to kill the perceived anti-consumer deal. Labor could get, say, 10% of the newly merged UA/US airline and this could be worth \$900 million if the estimates are correct. Throw in a 5%-10% pay raise, worth \$325 to \$650, and labor's take could be in the \$1.2 billion and \$1.6 billion range. Not a bad pay-off for a deal that is clearly better than the compensation package that can be derived from a standalone airline that can't benefit from \$1.5 - \$2 billion in cost and revenue synergies if a merger deal is killed because it is perceived to reward managers at the expense of consumer benefits.

Labor groups will take a short-term view of a merger, driven by their position on the seniority lists, regardless of what makes sense for the airline and the other stakeholders. Shareholder returns are not part of a labor equation when it relates to negotiating a new contract, but it is the value created by the merger that will allow higher compensation for rank and file.

### **Final thoughts**

After \$70 billion in inflation losses over the decade ending 2009, \$63 billion in the domestic market, the industry is ripe for consolidation. Balance sheets have been sucked dry of tangible equity and labor is biting at the bit to recoup 33% inflation-and size adjusted cuts in total compensation. The window to create the most value is open, *but* it will start closing as labor pressures for higher wages (\$3.3-6 billion) and higher airport PFC fees (\$2 billion higher) and security costs (\$2.7 billion by 2014) kick in. Also, higher fuel costs have become a catalyst, encouraging management to move towards protecting and enhancing shareholder value. Fuel costs in 2010 will be around \$6.4 billion higher than 2009's - \$80 base case this year and \$84 in 2011.

It is merger time in the airline industry and the UAL, US and CAL teams are likely to make a move that will benefit these airlines, labor, the industry, and even the consumer. If the merger rumors are true, and conventional wisdom is wrong (as I think it is), then if UAL makes a bid for US (or vice-versa), this will force CAL to enter into merger discussions. UAL wins if it merges with either US or CAL, even if the CAL deal is a better fit and creates more value. And, UAL labor prefers a CAL deal.

The best merger is one that involves a stock swap so as to avoid a control premium. Whether or not the deal is a takeover, or a stock swap merger, the benefits to shareholders and labor is an opportunity too large to ignore. For this reason I believe the US potential deal is real and should be consummated if CAL doesn't step up to the plate. Moreover, UAL should move fast before any political

momentum gathers enough steam to kill the deal, and labor will need to be involved as soon as practical and offered a deal that secures their support.

Paul Mifsud and Carlos Bonilla contributed to this research note. All estimates presented in this note reflect only the views of AirlineForecasts.