Centre for Asia Pacific Aviation

The fallacy of airline mergers: Two drunks holding unto each other will not walk straight – Pilarski

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The above is a quote of what I told the Wall Street Journal a few years ago when commenting on mergers. Two weak companies joining each other will not miraculously become one strong one. This is worth remembering in light of recent developments in the US where airlines are merging at an increasing rate. The interesting element is that the belief that mergers are good for the industry is an almost universally accepted truth. This opinion paper on airline mergers, 'The fallacy of airline mergers: Two drunks holding unto each other will not walk straight' is by Adam Pilarski, SVP of AVITAS Inc.

There are some undisputable facts. The world's airlines have lost around $60 billion since the year 2000. While this may not appear much to the reader in light of losses of some companies like AIG, it is real money. Another fact though is that the world airline industry has never really made money or at least did not recover the full cost of capital. The industry as a whole has been a destroyer of value for decades. There are many reasons for that fact, many of which discussed in my book "Why Can't We Make Money In Aviation?"

The reasons for the perennial loss-making of the airline industry

A number of people try to understand the reasons for the perennial loss-making of the airline industry. Some point out that the Low Cost Carriers (**LCC (/profiles/hot-issues/low-cost-carriers-lccs)**) are the way to go and legacy carriers are those losing money. The fact, though, is that some LCC lose money and go out of business while others prosper. Similarly some legacy carriers lose money while others like **Singapore Airlines (/profiles/airlines/singapore-airlines)** (SQ) or **FedEx (/profiles/airlines/fedex)** consistently make money.

"Overcapacity"

Among the reasons pointed out as the single most important factor for airline losses the most frequently mentioned is "overcapacity". I do not want to embarrass anybody in particular but almost all analysts, industry leaders and general pundits point to this factor as the major one contributing to airline industry losses. As one example, at a well attended aviation conference I chaired a panel of planning executives of relatively small airlines representing different parts of the world. Our panel represented **Royal Jordanian (/profiles/airlines/royal-jordanian-airlines)** , **Malaysia Airlines (/profiles/airlines/malaysia-airlines)** , Copa Airlines and **WestJet (/profiles/airlines/westjet)** , all profitable at that time. We discussed strategic issues of the industry and how these particular carriers managed to do well financially. Before our session the high ranking representative of **IATA (/profiles/industry-associations/iata)** , who sponsored the event, summarized the conference proceedings by stressing the one factor really needed to help world airlines: **consolidation (/profiles/hot-issues/mergers-and-consolidation)** . I was dumbstruck.

Here were leaders of successful but fairly small airlines who were told that in order to be really successful they should become big. Maybe as big as **United Airlines (/profiles/airlines/united-airlines)** which in 2005 lost US$21176 million while the top 150 airlines in the world that year lost US$20699 million (in other words, that year without United the world airlines would have been marginally profitable). Interestingly, such a view is so engrained in the psyche of aviation people that it is accepted as a universal fact.

When I started in the industry I remember "everybody" saying that in a few decades (at that time the future point discussed was the year 2000) there will be only about 4 airlines or airline alliances left in the world. This reminds me of the 1993 movie "Demolition Man" with Sylvester Stallone, Wesley Snipes and Sandra Bullock which dealt with a strange future of the year 2032. At that time in the movie there was only one type of restaurant in the US remaining, namely Taco Bell. This was the ultimate consolidation which makes as much sense as that talked about consolidation in the airline industry.

There is a need for only 3 airlines in the US?

The old arguments are being repeated again. This time, it turns out, there is a need for only 3 airlines in the US. Why three, you may ask? By asking you show more understanding than most aviation pundits. Why 3 airlines will be profitable while 6 will not is beyond me. The new 3 airlines will have the same management, labor relations and customer service as the previous 6 had.

The belief that consolidation will cure the chronic financial underperfomance of the airline industry is based on the simple assertion that bigger is better. Clearly there is evidence in the real world that some small airlines make money (and some do not) while some big airlines lose money (and some do not). If bigger were better than **Aeroflot (/profiles/airlines/aeroflot)** would have been the most successful airline in history. And United would not have entered bankruptcy. And clearly Pan Am or Eastern did not disappear because they were too small.

As mentioned above, "everybody knows" that we have excess **capacity (/profiles/hot-issues/traffic-and-capacity)** and too much competition, especially (pundits' favorite term) "destructive price competition". Let's look at this commonly held belief more closely. Obviously every business leader spouts such opinions. Yes, if we were to eliminate competition those remaining in business would have an easier job. If others do not charge less we could sell more. Granting an airline a monopoly position may seem good from the pure profit point of view though the long history of national airlines enjoying such a position does not provide much evidence of high profitability or efficiency. There is no business where the participants do not complain of too fierce competition and where they do not attempt to have a monopoly or at least a cartel type market structure. The only entity that enjoys lack of competition is the government and that organization is not willing to share its power.

Understanding the concept of "excess capacity"

Historically during recessions we had lower demand, hence planes were flying empty and load factors dropped being a sign of excess capacity. To understand the concept of "excess capacity" let's start with what economists call the "natural rate of unemployment" or a level of unemployment which in given social circumstances is close to the best we can achieve. There will always be some people in our economic system who will be unemployed ie those between jobs, recent graduates who are looking for a position etc. Hence we cannot have zero unemployment. In a similar way, there seems to be a natural level of load factors. Some aircraft have to make positioning flights late at night to assure the availability of the aircraft in the morning for necessary flights. Also because of spill we do not want to have flights 100% full. Such a situation would indicate that we are turning many people away.

This was the case in China where I remember flying with every flight totally sold out and even remember over 100% load factor flights (collapsible chairs in aisles). Hence we cannot have totally full airplanes. Recently "natural" load factors are inching upwards with better technology, planning and the ability of airlines to switch aircraft size to suit specific demand of the day and time.

Years ago load factors were believed to not be able to exceed 60%. This level moved up to 70% and now is probably seen as 80%. Higher levels, like close to 100% must be very inefficient. So, excess capacity can be defined as a level lower than the "natural level of load

Aircraft are flying fuller than ever before

Anybody who has flown in the last few years realizes that aircraft are flying fuller than ever before, hence we do not experience excess capacity. So how can all the pundits claim we have excess capacity? One of the more ingenious ways to prove that this is the case (a la "who are you going to believe – me or your lying eyes?") centers around a redefinition of excess capacity. Such a view claims that even if the aircraft were to fly 100 percent full there still is excess capacity, a view going against common sense and logic.

The proponents of such a view claim that, since airlines lose money, they must have excess capacity. Were they to cut capacity, **yields (/profiles/hot-issues/yields)** would go up and airlines would be profitable. Hence, ipso facto airlines lose money they have excess capacity. This is circular logic at its best. Airlines lose money because we have excess capacity. We can prove that airlines experience excess capacity because they lose money. Some well known supporters of such a view even are able to quantify their bizarre logic and calculated recently that we have exactly 7% excess capacity in the US. This was achieved by having models which assume that if we cut capacity by 7% that would lead to (another assumption) increased yields and eventually to a break even industry.

Obviously I do not believe we have excess capacity. I believe we have many other problems, one of the main ones being pricing. This, the reader should notice, is not a semantic exercise. If we have excess capacity which is the main culprit of the lack of profitability of the airline industry, we should cut capacity, encourage efforts to consolidate the industry etc. If on the other hand we have bad pricing, efforts should be made to reform this element of airline operations. Pete McGlade, VP of Schedule Planning at Southwest put this in proper perspective in 1999 when he said: "People who complain about overcapacity have high unit costs. If you don't have demand, you obviously have too many seats.

Southwest (on the other hand) has been overwhelmed with customer demand." Interestingly, airlines losing money and complaining about overcapacity have the freedom to reduce theirs. Rather, they insist that others (who may be profitable) do it so that those who do not know what they are doing can eventually climb out of the red. David Siegel, the CEO of **US Airways (/profiles/airlines/us-airways)** remarked in 2004 that the industry was not faced with an excess supply. Rather, he surmised, we had too much 10 cent (cost per mile) capacity and not enough six cent capacity. In other words excess capacity is not the problem: high costs, bad pricing, bad labor relations and incompetent management are the problems that need to be addressed.

Get rid of those who should not be in business

So, basically we should not try to eliminate capacity but rather get rid of those who should not be in business and encourage profitable enterprises to grow. How do we eliminate unprofitable capacity?

Since airlines lose money most observers look for solutions and for decades have suggested consolidation and mergers. These "universally accepted truths" are in my view mistaken. First of all, there is no evidence supporting the following: that there is too much capacity, that reducing capacity will increase profitability and that bigger is better, at least in airline size. Common sense and simple economics tell people that reducing supply causes prices to go up. But common sense and simple economics also tells us that an industry cannot destroy shareholders value for decades. Turns out that both of the mentioned above statements appear not to be supported by facts.

Why would mergers help?

Even if we were to accept the questionable assertion that we need to reduce capacity, why would mergers help? Mergers as discussed here, by the way, are not alliances or the takeover of a virtually bankrupt airline by another to take over its **routes (/profiles/hot-issues/route-changes)** and aircraft, like the "**merger (/profiles/hot-issues/mergers-and-consolidation)** " of TWA and **American Airlines (/profiles/airlines/american-airlines)** or of **Lufthansa (/profiles/airlines/lufthansa)** and **Austrian (/profiles/airlines/austrian-airlines)** . Airlines are free to reduce capacity on their own or to go bankrupt, mergers are not a prerequisite for capacity cuts. Pan Am and Eastern accounted for 22.7% of US capacity a decade before they ceased operation. Even a year before their ultimate demise they still amounted to over 10% of US capacity.

On the other hand, the share of US capacity of United, **Delta (/profiles/airlines/delta-air-lines)** and Northwest fell by 11 percentage points between the year 2000 and 2009. If we add American and US Air the share dropped by 18.3 percentage point or similar to the drop in involuntary capacity in 1991 as a result of Pan Am and Eastern bankruptcies. So, even without any airline officially exiting the market the combined macro effect on the industry was similar to the one experienced a couple of decades earlier.

Interestingly, if we compare the 3 legacy carriers which until 2009 did not **merge (/profiles/hot-issues/mergers-and-consolidation)** (UA, DL and NW) to those who did (AA with TWA and USAir with America West) we find out that their relative shares dropped by almost identical magnitudes. Looking at it in another way we know that total capacity in the US increased marginally between 2000 and 2009 (**traffic (/profiles/hot-issues/traffic-and-capacity)** increased more since load factors rose a lot). During the same period, the legacy carriers which did not merge had an annual drop in capacity of 3.1% while those who did (TW and US) dropped 3.0% capacity annually. Does anybody still want to argue that mergers help reduce capacity?

If mergers do not help reduce capacity, why do they happen?

If mergers do not help reduce capacity (not that I believe such a reduction is necessary), why do they happen? The cynical view is that many people benefit from them. There are the lawyers putting the deals together, the consultants proving that mergers are the best thing for humanity since the introduction of sex, the executives who utilize their golden parachutes in terms of huge severance payouts and the various constituents being bribed to accept a merger like cities being granted work protection clauses and so on.

It is educational to look into the basic premise of mergers. Of course there were some examples in history where mergers did work either for both parties or at least did save one party from disappearing. The benefits of mergers are usually touted mainly in terms of increased efficiency and cost savings. The story in most cases is simple. Bigger is better. A bigger airline will be able to negotiate better terms on purchases. It will eliminate duplications (a favorite term). Hence there will be only one CEO instead of the two before and there will be only one computer system and so on. The numbers presented in each case of applications to have mergers accepted by the regulatory agencies run into hundreds of millions or billions of dollars and sound very impressive and convincing.

I am not very convinced by such arguments. First of all, if an airline the size of United or Delta claims that they need to be bigger to achieve better purchasing contracts there clearly is a red flag pointing out to problems. How come SQ, being smaller, can be profitable? If UA could not achieve decent purchasing contracts when they were the largest airline in the world, what assurance do we have that if they get even larger they will finally be able to buy things cheap?

I am also highly skeptical regarding the savings of CEO salaries and the like. Having one overpaid chief executive instead of two sounds like an easy savings, say a cool $10 million a year. Except that usually a merger leads to a CEO at say $12 million plus a deputy CEO (from the "other" airline) at $7 million plus a lot of payments for departing executives who have golden parachutes. Plus you actually need more managerial supervision since running the business becomes more complicated: in addition to the usual need to manage the airline one needs management of coordination. Again, the basic premise of cost savings in mergers equals the belief that bigger is better. History and data related to airline profitability do not support such a view.

Monopoly positions

On the revenue side the plot thickens. Most improvements in revenue are likely to come from the new mega airline exploiting its monopoly position. This is why regulatory agencies review any proposed merger carefully. Saying mergers are good because airlines face less competition and can charge more is a fairly empty compliment.

Balanced with the questionable cost savings and uncertain revenue improvements have to be the obvious costs of the merger. These include a host of labor problems including merging seniority lists and coordinating labor rules. These are always contentious issues which result in conflict and usually higher labor costs. Even more complicated issues involve forging a joint company culture.

Merger activity in the US will not lead to added profitability

Overall, the recent merger activity in the US will not lead to added profitability of the airline industry. There are no indications that this will lead to an additional capacity cut beyond one which could be expected anyhow. Some mergers may generate positive results but similar improvements could be achieved just by running the airlines better. The cost savings are elusive and illusory. There were some mergers in Europe though, so far, they were of a different kind than the ones contemplated in the US. **Air France (/profiles/airlines/air-france)** /**KLM (/profiles/airlines/klm-royal-dutch-airlines)** are run as two separate airlines. BA and **Iberia (/profiles/airlines/iberia-airlines)** are still in planning stages. The Lufthansa takeovers were not mergers in the way I define them. Hopefully airlines around the world, and especially in Asia, will not parrot the behavior of US airlines.

In the real world these mergers will not change much. Legacy carriers will shrink capacity, the overall industry will recover from the **recession (/profiles/hot-issues/economy)** , the number of airplanes flying will be similar to the one if mergers did not happen and values of aircraft will not be affected.

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