Top ten false claims about the need for U.S. airline mergers

By Hubert Horan

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1. **"There's a strong, growing groundswell of support for airline mergers."** This is complete nonsense. Only three very narrow groups are arguing for Legacy airline mergers in the U.S.—**(a)** individual hedge funds who don't understand industry fundamentals but have made big speculative gambles on consolidation, **(b)** a handful of very senior airline executives who are finding it very difficult to generate sustainable profits but would realize multi-million personal payouts in most merger scenarios and **(c)** Wall Street firms, lawyers and consultants lusting after big fees. No one with any long-term stake in these airlines is advocating mergers. There is no objective, quantitative analysis showing competitive or efficiency gains, or long-term improvements in corporate value. These same three groups generated huge publicity for the "pro-merger" case in early 2006. Nothing happened then, and no one else has taken up the cause since. The Big 6 Legacy carriers have been intensively studying merger/consolidation scenarios for ten years, but the only carriers that could justify merging (America West-US Airways) were bankrupt and on the verge of liquidation.

2. "**Airline mergers would be part of a natural industry shakeout process.**" A wholly dishonest claim. "Natural" industry shakeouts involve wiping out the managements and investors of small, weak, inefficient competitors in a declining industry, and the displacement of companies using obsolete technologies and business models. These mergers would protect and entrench weak airlines such as United and Delta that haven't generated returns for shareholders for over a decade and would enrich many of the same managers that drove them into bankruptcy. A true shakeout might consolidate smaller airlines with limited scale or network scope, but does anyone actually believe that United and Delta are too small to compete? Does anyone believe that aviation is a declining, shrinking industry? A true shakeout would allow more efficient carriers such as Southwest and AirTran to grow faster by dramatically shrinking unprofitable Legacy capacity. The misrepresentations about "natural shakeouts" can also be seen in Europe where very large airlines with high costs and traditional business models (Air France and KLM in Europe) are using mergers to make it harder for airlines with lower costs and lower fares (such as Ryanair and Easyjet) to compete.

3. **"Airline mergers would be a necessary response to $100/bbl fuel and a downturn in the business cycle."** This is the exact opposite of the truth. If no one could justify a Legacy merger when revenue, cash flow and access to capital were extremely strong, then they certainly can't be justified now. Cash flow becomes incredibly critical to airlines during an economic downturn, and multi-billion dollar merger costs would rapidly drain needed reserves. The revenue risk of implementation problems becomes much greater when demand is weak. The argument that mergers are needed now assumes that airline mangers had already been doing a fantastic job optimizing fleet, network structure, information technology, employee relations, operational efficiency, customer service, brand marketing, supplier relationships, capital structure, and things like that, and therefore, the only option left as conditions worsen is to change the number of airlines. Wall Street analysts and airline executives are pushing the same merger PR arguments that they did when fuel was $50/bbl and when demand and prices were extremely robust, and the money to finance deals was practically falling off of trees.

4. **"Airline mergers could be implemented with limited risk."** It is hard to believe that anyone could make this general claim with a straight face. A merger between two big 6 US Legacy carriers would cost something on the order of $5 billion to implement, and there has never been a merger between large airlines that was both an operational and financial success. There have been mergers between large airlines where strong potential synergies were wiped out by terrible implementation (Northwest-Republic, Continental-People Express) and mergers with careful, expensive implementation that generated no long-term financial benefits (Delta-Western) and mergers that were across the board failures (American-TWA), and all past cases involved smaller operations than cases like Delta-Northwest or United-Continental

would today. The slightest hiccups while integrating complex computer systems, aircraft maintenance programs, employee operating practices and seniority lists and the like could cause huge disruptions that would alienate customers for years. More importantly, the financial structure these mergers would follow appears designed to ensure the worst possible implementation. All of the big financial gains (stock price bump triggered by the merger announcements, management change-in-control bonuses, fees to investment bankers, lawyers and consultants) would be realized prior to implementation, and none of these people would have any financial incentive to manage the operational and customer service risks.

5. "Airline mergers would generate significant operating synergies and strengthen efficiency." None of the merger advocates have presented an iota of evidence supporting this claim. Any merger could generate some savings, but no airline merger has ever been justified primarily by cost synergies, and these savings could never cover the multi-billion dollar implementation costs and disruption risks. All of the costs are 100% certain, and need to be paid for up front while the synergies are much less certain and might take years to realize. Legacy carriers have very little potential for further scale economies, unless you believe that Aeroflot under the USSR was a model of efficiency. If you merge airlines in bankruptcy (as with last year's proposed Delta-US Airways merger) you can maximize cost synergies by restructuring hubs, fleets, and union/vendor contracts as part of the reorganization process (although you'd still face significant implementation challenges and risks). The cost of merging Delta and Northwest outside of bankruptcy protection is much higher because they have much less ability to shed the assets and staff that would become redundant after a merger.

6. "Mergers are required to rationalize excess industry capacity." Once again, this is the exact opposite of the truth. The industry does have "excess" (structurally unprofitable) capacity, and higher fuel prices mean that even more capacity is unsustainable. But nobody needs expensive, risky mergers to cut this capacity, and consolidation will actually make it more difficult to bring supply and demand back into line. Mergers give disadvantaged employees, lessors, local airports and politicians greater leverage to block or disrupt capacity cuts, all of whom can point to select insiders (hedge funds, senior executives) making big short-term gains at their expense.

7. "U.S. Airlines need to merge in order to compete with foreign airlines that are better financed and offer better service." The claim that US carriers have a distinct competitive disadvantage against foreign airlines contradicts all recent evidence—Legacy hubs provide a highly efficient means of serving many international markets, international routes are highly profitable and U.S carriers are shifting capacity to them as fast as possible. Obviously US carriers can't compete on some routes, but foreign carriers can't compete on others. Nothing in these long haul/overseas markets has changed in recent years that created a competitive deficiency that would be fixed by a Legacy merger. If US carrier service isn't as good as it could be, disruptive mergers that reduce competition will only make the problem worse.

8. "Airline managers have an obligation to pursue mergers in order to boost their falling stock prices." The people arguing this do not seem to understand the difference between sustainable growth in shareholder value and short-term stock price manipulation. This is not a plan to strengthen airline finances, but a scheme to enrich one narrow group of investors at the expense of every other group of investors. Many merger advocates (including certain hedge funds, day traders and their Wall Street supporters) know that steady press speculation about merger battles and bidding wars can pump up prices and trading volumes, as was witnessed following the merger PR campaign last year. The merger advocates are looking for speculative profits and trading fees that contribute nothing to the financial strength of the airlines. Senior executives can pocket both multi-million dollar "performance" bonuses (which are tied to short-term equity swings rather than sustainable gains in corporate value) plus multi-million dollar "change-in-control" payments following the merger. The merger does nothing to improve fundamentals such as competitiveness or efficiency, and potential savings are dwarfed by implementation costs, operational disruptions, and other problems. Corporate value is destroyed, reducing returns and increasing the risk faced by lenders, lessors and bondholders. As witnessed with US Airways and Delta after last year's merger mania died down, the stock price quickly collapses, creating huge losses for many investors, and making it even more difficult for airlines to attract long-term investment in the future.

9. "**Consolidation would strengthen the entire industry.**" Widespread consolidation is actually the biggest threat to consumers, employees and investors. It hasn't happened yet, but hypothetically one could design an isolated Legacy merger that actually created long-term corporate value based on improved efficiency or competitiveness. But the "mergers would be wonderful" PR arguments ignore the economics of each case because the real objective is to create a general merger frenzy. The first megamerger proposal could quickly trigger additional defensive mergers permanently reducing the number of airline competitors. The stock speculators who have been demanding mergers are clearly gambling on this scenario, and it produces a massive payday for the lawyers and investment bankers. Thus you can't evaluate a potential merger such as Delta-Northwest in isolation; you have to look at how the entire wave of consolidation would affect industry efficiency and performance. Two or three megamergers in quick succession, just as an economic downturn hits, each incurring multi-billion implementation costs and huge operational risks, each entrenching weak management teams, each unleashing union hostilities and systems integration nightmares, could greatly accelerate the next round of industry bankruptcy cases.

10. "**Airline mergers would increase long-term corporate value without harming consumers.**" Legacy megagmergers won't increase the level of service operated, won't improve the quality of customer service, could easily increase costs and reduce efficiency, and would increase overall financial risk while seriously damaging certain portions of the capital structure. The only way megamergers could overcome these problems and generate a net increase in corporate value is by artificially distorting competition, or to put it directly, by screwing consumers. Big profits from consolidation depends on artificial barriers to LCCs and other more efficient competitors (so less efficient airlines can raise prices with impunity) and a level of overall market domination that makes it easy to discipline and challenges to the oligopoly status quo. In the domestic US market, consolidating the 6 Legacy carriers into 3 larger ones wouldn't create enough artificial market "power" to drive fares high enough to justify these expensive mergers (although consumers using the constrained airports of the Northeast would undoubtedly suffer). The real threat to consumers is in international markets, especially the North Atlantic. These markets are rapidly growing, are already highly profitable, but have huge entry barriers that make it impossible for new, more efficient airlines (such as LCCs) to compete. The "industry consolidation" that has been actively advocated by United, Air France, Lufthansa and big airlines would quickly create a North Atlantic oligopoly where two competitors had 90% of all service between the United States and continental Europe. The artificial profits from rigging these long haul markets could easily justify the multi-billion cost of industry consolidation. Much of the Wall Street/industry discussion about alternative merger pairings (United with Continental or Delta?) focuses on how this oligopoly might emerge, and how quickly it might spread to the Pacific and other markets. Much of the discussion about "natural industry shakeouts" or how mergers are the only way to shed excess capacity or respond to high fuel prices is simply a PR smokescreen for megacarriers hoping to radically reduce international competition.

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