DAN THISDELL LONDON

SIZE STILL MATTERS

How big is big enough to allow economies of scale to start having a noticeable impact on a carrier's bottom line, and are airline mergers proving to be ultimately successful anyway?

When International Airlines Group started trading on the London and Madrid stock exchanges two years ago, investors were welcomed to "a major new player in international aviation" – the sixth-largest globally and third in Europe by revenue, at a combined €14 billion ($19 billion) and with more than 400 aircraft. Investors were also promised the merger of British Airways and Spain's Iberia would lead to "annual synergies of €400 million from year five (since raised to €450 million), while benefiting IAG shareholders and BA and Iberia customers and staff".

At the time, former Iberia chief executive turned IAG chairman Antonio Vazquez said the link-up was vital to ensure the airlines remained competitive in the long-term: "Both companies now have the feeling that, working together, everything is possible because we have a much broader way of looking at the world."

The group, explicitly created for growth as well as efficiency, has unified its cargo businesses, bought BMI from Lufthansa and then sold BMI's regional business. It is now in the process of acquiring Spanish low-cost carrier Vueling. But plan and reality have diverged.

In November, IAG unveiled "a comprehensive plan to save Iberia after record losses". To stem cash losses by mid-2013 and achieve a €600 million profitability turnaround, the proposals called for slashing 15% from network capacity and losing 25 aircraft and 4,500 jobs.

Although the number of job cuts was reduced to 3,147, unions rejected the plan and called for industrial action. When an end-January agreement deadline passed, IAG announced it would proceed with the capacity cuts and "alternative plans to return Iberia to break-even", agreement or not.

By their own timetable, Vazquez and BA boss turned IAG chief executive Willie Walsh have three years to achieve the promised €400 million in synergies – one third from revenue and two thirds from cost, so the merger may ultimately prove successful.

The jury is still out on the merger between United and Continental

Meanwhile, the jury is still out on the ultimate merger – between United and Continental. The world's biggest group would have made a $589 million net profit in 2012 but for some $1.3 billion in charges related to the merger, which went through in 2010. In short, it is painfully clear that size is no panacea. Indeed, industry leaders are being advised to consider the delicate balance between scale and scope of operations.

Roger de Peyrecave, UK airline leader at consultants PwC, says a vibrant mergers and acquisitions market reflects top carriers' belief that pushing for consolidation and scale is their best strategy to access growing markets and achieve step-change performance in mature markets, cut costs and deliver sustainable profitability with an acceptable return on capital. And, he adds, achieving scale in a consolidated market is seen as the way to ensure your company is one of the long-term winners.

He says that while he doubts any airline is likely to grow too large to be profitable – and he believes there are generally benefits in terms of purchasing power and fleet rationalisation to be gained from greater scale – it is increasingly important to recognise the difficulty faced when trying to achieve scale economies by combining long- and short-haul operations. Signs of distress are most evident in what de Peyrecave calls "the squeezed middle". IAG's BMI take-over was only one case of a mid-tier operator being squeezed out – Malev and Spanair being other recent examples.

Ultimately, says de Peyrecave, mid-sized carriers with a mix of short- and long-haul operations are struggling to stay profitable, mainly because they lack the scale to optimise either part of the business. In Europe particularly, he says, there is a good chance the industry will become stratified, with short-haul specialists – principally low-cost carriers – moving passengers who choose to "self-connect" to long-haul flights at hub airports.

Such stratification allows carriers to optimise their business plan, he notes, for example by running one-type fleets where possible, to maximise flexibility.

LONG AND SHORT OF IT

But at any scale, the challenge of running short-haul routes to serve as feeders for long-haul flights can be daunting. Network carriers cannot avoid that mix, though, and increased scale can have some powerful benefits at the margin. Oman Air chief executive Wayne Pearce says there are overhead efficiencies to be had from scale, but the first benefit comes in load factor. All of Oman's studies, he adds, point to 50 aircraft as a mark to expect a leap in efficiency; Pearce's plans to add six 737s, six 787s and some other aircraft are well-advanced.

Separating short- and long-haul flying makes sense in one critical respect: a short-haul low-cost carrier such as Ryanair optimises its routes and schedules without regard for the timetable of any long-haul operator. Carriers trying to run a long-haul and feeder service do not have that luxury, and pay for it in inefficiency. But even long-haul specialists cannot look to mere scale to save them from high costs because, in this industry, there are real constraints on growth. National regulations barring foreign ownership and favouring flag carriers restrict growth by merger or acquisition. Such "natural limits" prevent airlines from becoming global conglomerates.

A probable exception, says de Peyrecave, are the big Gulf carriers. Emirates or Etihad are exploiting their geographic hub position in an attempt to dominate the long-haul trade, with the added advantage of efficiency as their all-new fleets can be optimised around relatively few types suitable to

€450m

Promised synergies when BA and Iberia were merged


British Airways

similar routes. Even these carriers, he adds, will come up against growth-limiting national regulatory barriers in the Americas.

Moreover, in any industry marginal scale economies diminish with growth, and it would be unwise to assume airlines are unique in being able to escape the onset of diseconomies of scale when the cost of managing a huge operation starts to rise faster than profit growth. When it comes to that ultimate breaking cost – fuel – there are few, if any, scale economies to be had.

Is there a "right size" for an airline? Aviation consultant and former BA executive John Strickland sees no definitive answer to that question as there are examples of successful carriers across the size spectrum. He says very small airlines, say with 10 aircraft at most, are particularly vulnerable to cost inefficiencies associated with split fleets; they also struggle with disproportionately high marketing costs if their key routes are not a coherent set of destinations. But very-large carriers can have similar problems, certainly when it comes to split fleets. Some of the big groups also have duplicated costs such as major offices; says Strickland, there is "danger in size for size's stake".

GROWN ORGANICALLY

The distinction to recognise, he says, is the one between airlines which have grown organically and those that have expanded by merger or acquisition. Examples of successful expansion achieved largely through organic growth include Easyjet or Ryanair, which enjoy genuine economies of scale; one-type fleets minimise maintenance and training costs, while fleets, routes and front-line headcount have grown faster than management overheads. Moreover, such carriers have maintained consistent working and IT systems and company cultures.

By contrast, big carriers created by merger or acquisition – especially in multicultural Europe – can easily be inefficient. Welding companies together does not erase legacy issues and, Strickland warns, management underestimates the significance of "human factors" at its peril. Contract terms and employee expectations differ between company and national cultures, and cannot be changed quickly – local issues still prevail. Strickland cites Air France-KLM, which is still seen as separate companies by its passengers and continues to grapple with cost issues unique to each entity. In IAG, he sees a struggle to bring to Iberia the cost-saving and labour-relations transformations achieved pre-merger at BA.

Revenue growth is not easy to sustain in an expanded company

Recognising the management challenge of merged companies is huge, Strickland advises striving for simplicity in fleet, systems and company culture: "Whether you've got 50 aircraft or 200, keep things simple." In that regard the airline industry is no different to any other. When it comes to mergers and acquisitions, the dazzling, big-strategy allure of moving chess pieces on the boardroom table often collides with the hard reality of managing the result. Across industries, studies typically find that three-quarters of mergers can be deemed failures. Revenue growth is not easy to sustain in an expanded company, if for no other reason than customers who enjoyed personal attention feel alienated by a big corporation.

Cost savings – the so-called synergies merger-promoting managers like to forecast – are more often than not elusive. As recruitment agent Heidrick & Struggles observed in a recent paper: "Many companies fail to realise their leadership team may not be up to the job of leading a larger and more complex organisation."

Airlines, therefore, may seek growth as one route to the unit cost reduction needed to maintain profitability, but eventually it will be necessary to control costs without growth, and carriers which fail to do that in the short term may never be able to do it. ■

Read about the latest mega-merger, between American Airlines and US Airways, at: **flightglobal.com/AA-US**