Consolidation in the skies

As the region's airline industry continues to grow, will we witness an influx in the number of mergers and acquisitions in the Middle East?

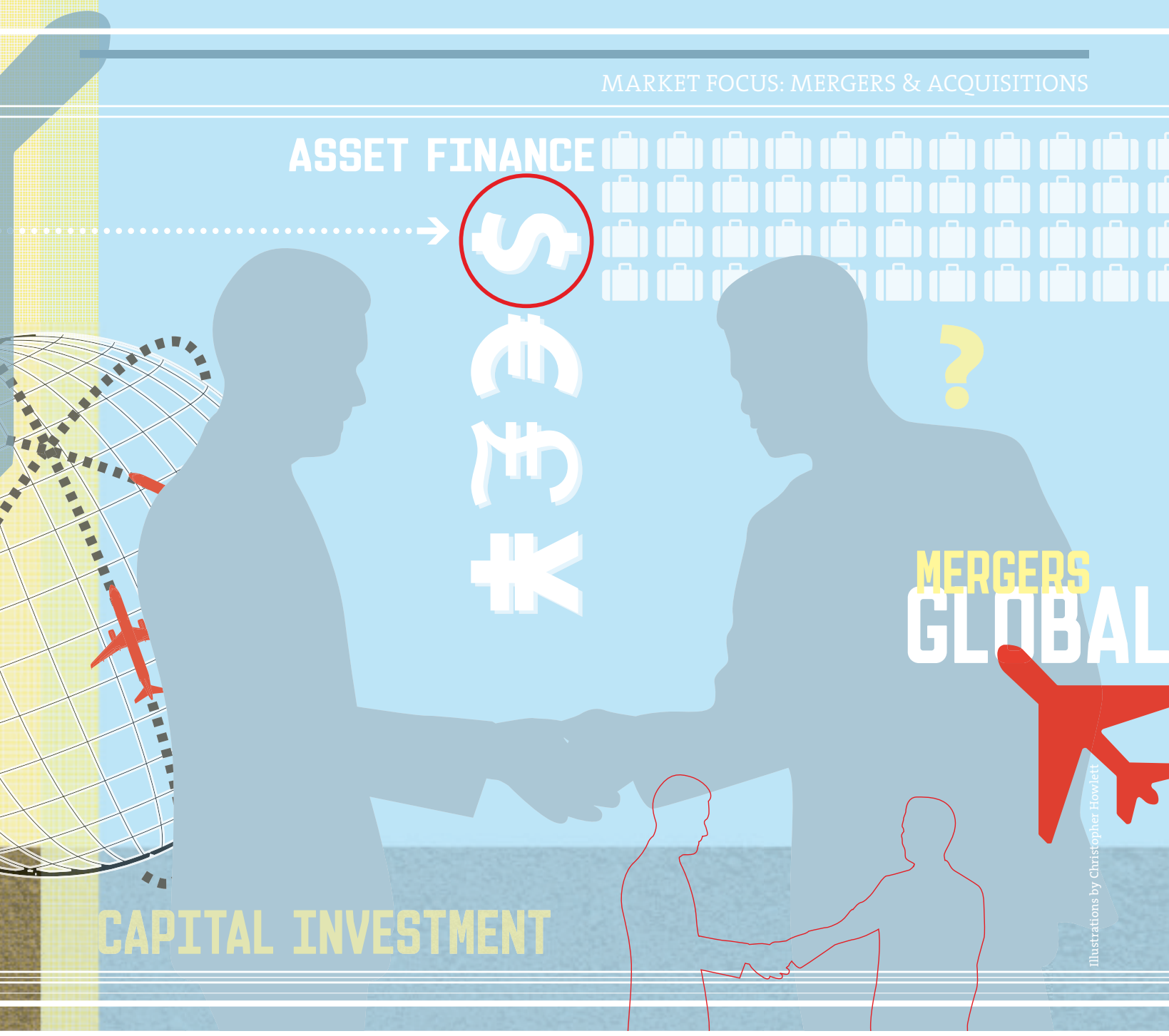
Words by Nadia Khan

Mergers and acquisitions in the competitive airline world are often highly complicated transactions with enormous global market implications for the sector. For airlines, the benefits of such a transaction can be far-reaching. By providing an expansion of alternative routes, a merger or acquisition can give a carrier access to an already established market without having to build up a network from scratch. Whilst passengers may complain that airline mergers spell a hike in airfares due to the reduced market competition, it enables the airlines involved to reach much higher operating margins.

Joining forces with another carrier can also powerfully strengthen an airline's dominance in the global industry as evidenced by some of the high-profile airline mergers in the US and Europe. But as the rate of growth amongst the Middle East's airlines continues to outpace its western counterparts, has the time come to witness an upsurge in airline acquisitions and mergers in the region? According to Emma Giddings, an Abu Dhabi-based partner specialising in asset finance at international law firm Norton Rose, airlines are currently having to make long-term decisions regarding major capital investments (primarily fleet-related) on the basis of business plans which are subject to a large number of uncertainties. This challenging environment is compounded by the usual suspects, such as volatile fuel price, ever increasing passenger duties and new environmental taxes, all topped off by an increasingly uncertain outlook for the global economy. In theory, Giddings suggests, all of these factors point in the direction of consolidation for the sector. "Larger airlines are better positioned to negotiate favourable deals with aircraft manufacturers, financing banks, lessors and other suppliers," she explains. "They are also better positioned to withstand the impact of volatility in their cost base." An acquisition can also give an airline access to valuable assets which it may not have been able to obtain otherwise, for example slots at congested airports. "The outcome of many mergers may lead to financially stronger airlines better able to invest in their fleets and other infrastructure, thereby allowing them to compete more effectively," says Giddings.

With so many benefits, it comes as no surprise that some of the Middle East's stronger airlines have begun dabbling in the mergers and acquisitions game in an attempt to further consolidate their leadership position in the industry. Earlier this year, Etihad Airways looked set to make its second airline acquisition in an agreement to acquire a 40% share in Air Seychelles. This involves both Etihad and the Seychelles government pumping US$20 million into the state-owed carrier with the Abu Dhabi-based airline taking on a five-year management contract to boost Air Seychelles' growth long-term. The development comes hot on the tails of Etihad's announcement last year that it would be spending $94.9 million to increase its stake in Germany's airberlin from 3% to more than 29%. Not to be left behind, the highly ambitious Qatar Airways acquired a 35% stake in one of Europe's biggest all-cargo operators, Cargolux last year, and has been openly eyeballing Europe for further potential acquisitions.

Despite this recent spate of activity, full-on mergers along the lines of the infamous Air France-KLM union in 2004 appear to be much less likely to happen in the Middle East. "Many carriers are state owned, which would make consolidation difficult," Giddings points out. "The most successful regional carriers may be more inclined to acquire airline businesses outside of the region as a means of pursuing their growth



Illustrations by Christopher Howlett

strategy rather than within the Middle East or otherwise pursue strategic alliances to expand their route network." But why is the usually fearless Middle East's airline industry so reserved when it comes to major mergers? "Consolidation tends to require a catalyst," suggests Giddings. "This might for example be regulatory change facilitating airline mergers, or simply financial difficulties resulting from economic condition which effectively force consolidation."

Deregulation has often been quoted as being a crucial key to stimulating mergers and acquisitions. Rend Stephan, partner and managing director at the Boston Consulting Group, points to deregulated, highly competitive and fragmented markets with low/negative profitability as being more conducive to this type of activity. High route overlap between the competing airlines and airport slot restrictions are also cited as key drivers for integration. "Today, we do not see these clear indications for mergers between the existing Middle Eastern airlines," he states. "The landscape is dominated by three mega-carriers (Emirates, Qatar Airways and Etihad) operating from different airports without a significant capacity shortage. Other airlines have gradually revisited their future strategies and are likely to maintain a smaller footprint by focusing on serving the needs of their local markets." Over the next 5-10 years, however, Stephan maintains that Middle Eastern mega-carriers could well pursue a selective shareholding and acquisition strategy to increase the reach of their feeder networks and circumvent restrictive route allocation in attractive markets. "Their strong growth trajectory and cash generation could facilitate such strategies while legacy carriers around the world are focused on improving their operational and financial positions," he says.

Other industry experts concur. Like Stephan, John Strickland, director of UK-based JLS consulting, believes that open market conditions with a range of carriers is what make mergers and acquisitions much more popular. "Some countries in the Gulf region still lack 'open skies' and this is not

conducive to sustaining the best choice of services and the development of the most dynamic airlines," he states. "But then, some of these carriers would simply not survive in a liberal environment. Presently, there is not a market imperative for them to do so outside the government supported aviation policy which prevails in some countries."

According to Mauricio Zuazua, principal at AT Kearney Middle East, whilst deregulation in the sense of privatisation could be a possible driver for integration, mergers are unlikely due to local governments seeing their airlines as a strategic investment to grow the local economy. "Successfully managing such a merger and extracting the benefits is a major challenge of these airlines due to a lack of experience when it comes to merger integration, whereas their western counterparts are very experienced with mergers," says Zuazua, pointing to Germany's Lufthansa as an example, with its impressive track record of airline purchases, including Austrian Airlines, Swiss Air and BMI. He believes instead that the better financial position of some of the Middle East's airlines makes them interesting candidates to bail out ailing airlines around the world. "Usually airlines need to feel that they will greatly benefit by the merger," says Zuazua. "Often these mergers are driven by one airline having serious financial difficulties, such as Etihad Airways' investment into airberlin." Indeed, the Abu Dhabi carrier has committed to financing up to $255 million over the next five years into its latest acquisition.

There is growing indication that this type of airline acquisition may well increase in the Middle East as airlines elsewhere in the world struggle to financially recover from the economic recession. "Both Qatar and Etihad clearly have the hunger to continue to expand the networks at the end of their long-haul routes," says Antony Single, counsel at the Abu Dhabi office of leading law firm Clifford Chance. "I am not sure we are ready for an Etihad-Qatar Airways merger in the same vein as Air France-KLM, but it will be interesting to see what acquisitions there are by the major players in Africa, Asia and Europe as part of their continued expansion into these markets."

Single is also quick to point out that there are also other less complicated and expensive ways to achieve many of the objectives of a merger or acquisition, such as expansion into new market, access to new routes or slots or joint ventures into new market where local partnership is needed for success. "Airlines do not necessarily need to go straight for a merger. Across our global practice we have seen a number of these benefits being achieved through joint ventures, code sharing and the global airline alliances," he says.

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Toby Stokes, EMEIA aviation sector leader at Ernst & Young also agrees that, when faced with regulatory challenges, airlines are often forced to turn to alternative strategies of cooperation via joint ventures, revenue sharing and codeshare arrangements. "Alliances and other forms of business agreements are becoming more commonplace in the industry globally," he says. "This helps to share costs and offer a wider network and benefits to passengers, as well as to comply with the various operating and regulatory regimes of individual countries." He points to increased Middle East activity within the big global alliances such as Royal Jordanian becoming a member of OneWorld and Saudi Arabian Airlines recently joining Skyteam.

It appears that, for now at least, an influx of mergers in the Middle East's airline industry is not on the cards. "Globally, we have been seeing more and more consolidation in the airline industry, with the merger of British Airways and Iberia and of Continental and United being the two latest big consolidations," says Stokes. "But to date, consolidation has been focused on the mature markets of North America and Europe, where airlines face different challenges to those operating in the Middle East." The main difference appears to be largely underpinned by the aviation regulatory environment in each country or region. "Currently the majority of the world's aviation markets are still highly regulated through limited access or foreign ownership restrictions, thereby reducing the opportunity for extensive cross border airline activity," he explains.

With full-scale deregulation in the Middle East's airline industry unlikely to happen anytime soon, large scale mergers appear equally unlikely. "Unless we start seeing deregulation in the sense of privatisation in the region, mergers are unlikely due to the local governments seeing their airlines as a strategic investment to grow the local economy," says AT Kearney's Zuazua. "We can, however, expect to see future investments into European and Asian airlines by Middle East's operators to further increase their reach and network." AVB