

# **“Alliances vs. Mergers in Passenger Air Transport”**

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## **Abstract:**

This paper analyses the two main forms of cooperation, mergers and alliances, in passenger air transport. The two forms are being compared with regards to their pertinence to generate synergies. Based on theoretic assessments and observations from the business practice strengths and weaknesses of each form of cooperation are being reviewed. The results show that no general conclusion can be drawn as to what form of cooperation is superior in generating synergies, according to their theoretical abilities. Furthermore, it is being suspected that both forms leave a significant amount of potential synergies unused.

*Keywords: airlines, airline management, synergies*

# 1. Introduction

Since the deregulation of air transport markets in the US (1978) and the European Union (1988) competition has increased intensively in the airline business. The rise of Low Cost Carriers, which have introduced a new business model, has sparked not just price, but also product competition. Moreover, the airline industry, and also to some extent entire air transport industry, is prone to shocks in the business cycle. Demand shocks, such as those caused by the 9/11 attacks, the SARS epidemic or the global and financial crisis have disproportionate repercussions on the airlines' balance sheets and financial positions. Despite strong liberalization, air transport markets remain highly regulated in some areas, such as restrictive bilateral agreements or restrictive ownership rights. Airlines struggle to operate in such an environment and try to cope with their business environment. One means to do this is to forge cooperations, such as mergers or alliances.

While mergers were the dominant form of cooperation in the US after liberalization, in Europe mostly alliances were formed, for example between Lufthansa and smaller regional partners that serve as feeder airlines. In order to provide passengers with a global network, international alliances were the only option, because of restricted cabotage. Hence, alliances and mergers have been part of corporate strategy for a long time. Especially in Europe things began to change in the last couple of years, airlines started to form mergers across national borders as well as with regional partners. Also in international alliances activities got stirred up. The question arising from this is whether these activities are actually undertaken due to potential synergies or may there be found another reason?

To address this question this paper looks at mergers and alliances from a theoretical point of view and then analyses as to how they compare to the actual business practice. Can we see that the theoretical ground for cooperation match with reality? The paper will compare the two forms of cooperation with respect to their pertinence for the airline business. Focus will be on the passenger traffic of airlines. Based on theoretical assessments and observations from the business practice strengths and weaknesses of each form of cooperation are being reviewed.

The next chapter will shortly introduce the characteristics of the air transport industry and point out why certain characteristics make certain forms of cooperation so beneficial in this industry. The third chapter will introduce the most important concepts and aspects of alliances and the fourth chapter will do the same with mergers. The fifth chapter will then bring these concepts together and compare mergers and alliances in air passenger transport. The final chapter will conduct a reality check by comparing actual examples of mergers and alliances to show the limitations of the theoretical findings. Furthermore, it summarises and concludes.

## 2. Characteristics of the Air Transport Industry

“The airline industry is a paradox. In terms of its operations it is the most international of industries, yet in term of ownership and control it is almost exclusively national.” (Doganis, 2001, p. 19)

In the last couple of decades the aviation industry faced considerable efforts of deregulation, making cooperation easier and giving market participants more choices.<sup>1</sup> As in any other industry all forms<sup>2</sup>

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<sup>1</sup> E.g. in destinations or cooperation partners.

of cooperation have to be approved by one or even more national authorities concerning their effects on competition in the relevant market(s). For an alliance to become “complete” it also needs to apply for antitrust immunity in order to be able to cooperate on financial issues as well (Doganis, 2001).

Another example that airlines are limited in their choices of cooperation is the EU – US Open Aviation Area. It came into effect in 2008 and gave airlines further choices in destinations, but until today it contains high restrictions on US ownership rules, making mergers between European and American airlines impossible (Doganis, 2001).

That the possibility of cooperation is an important option in the aviation industry, especially for airlines was made clear by e.g. September 11<sup>th</sup>, SARS or the oil crises. On the one hand the industry is threatened by sudden shocks, demanding flexibility to quickly increase revenues and overcome the crises. In such a situation an alliance can be helpful. On the other hand constantly low profit margins that hardly exceeded 5% even in times of growing passenger numbers<sup>3</sup> put pressure on airlines to reduce their costs. A merger seems to be the favoured form of cooperation in this kind of situation (Pilarski, 2007).

To clarify this point the following two chapters will look deeper into the characteristics and types of alliances and mergers in an overall theoretical view.

### 3. Characteristics and types of Alliances

The origin of the strategic alliance concept is unclear. Some believe it leads back to Michael Porter when he put it on a level with the coalition. Others are of the opinion that it was created by the consultants of McKinsey & Company to strengthen the attractiveness of an older concept. Therefore there is no generally accepted definition of the concept, only the characteristics are formulated:

- Cooperation specific qualities

Active cooperation is restricted to one or more functional areas (Pricewaterhouse Cooper, 1995) while the legal and commercial independence of the partners stays intact except in the cooperating areas (ECA, 2008).

- Strategic component & time frame

An alliance is usually formed to secure and improve the competitive position of the partnering companies (Oum, Park, Zhang, 2000). To accomplish this, the alliance activities need to be integrated into corporate planning (Schäfer, 2003) and the partners need to share resources and potentials which are relevant for competition (Oum et al, 2000). This makes it difficult to name a time frame for the cooperation. Usually it is assumed that the cooperation ends with the completion of the project goal (Schäfer, 2003). Since strengthening the

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<sup>2</sup> In this case merger and alliances are considered as the forms of choice.

<sup>3</sup> Only a few airlines managed profit margins around 10%, namely Southwest, Fed Ex, Singapore Airlines and British Airways.

competition position is a long time goal it seems that the time frame for alliance cooperation is also set to be long term (Oum et al, 2000).

- Internationality & Company size

The majority of today's alliances are used to generate economic growth or to develop a new market or transcontinental connections. Such goals usually implement some degree of global ambition (Iatrou & Oretti, 2007). Mostly global ambitions need to be backed by financial abilities. Bigger firms tend to fulfil this requirement more easily than smaller ones, so it is assumed that bigger firms will participate in alliances more frequently but not solely. Also small and medium firms partner up in alliances, but they tend to do this in the background (Schäfer, 2003).

Since there is no general definition of the alliance concept several types of this concept emerged. To clarify the different relationships between the firms in today's airline alliances the most important types are being described below. The description will follow the concept of Kleymann & Seristö (2004), which is based on the alliance network structure:

- Dominated Network

This alliance type is controlled by two main partners, which exceed all other partners in size and power. All other members of the alliance belong to the network of one of the dominant main partners and do not<sup>4</sup> interact with each other. Therefore, almost all alliance decisions are formulated between the main partners and then communicated to their minor partners.

A real world example for such an alliance type is the early KLM-Northwest alliance<sup>5</sup> and the current Oneworld alliance. Though the Oneworld partners began to bring forward stronger coordination between the minor partners across the main partner's networks, the orientation of the alliance is still governed significantly by British Airways and American Airlines.

- Confederation

The partners establish a superior formal structure, which is not an active alliance member and to whom all alliance members form a connection. The formal structure has the duty to formulate alliance goals and to coordinate its activities. This formulation of course is not always easy, because the members try to realize their own interests. In this context the partners have to be able to reach a compromise, which tends to be easier when partners are more homogeneous in their structures.

Organised in such a way are the Star Alliance and Sky Team. The Star Alliance on the one hand installed a so called Management Team that is able to execute all management activities concerning the alliance. Sky Team on the other hand has a Governing Board that is allowed to make proposals, but cannot carry out any actual alliance activities.

- Federation

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<sup>4</sup> Or very rarely.

<sup>5</sup> which is now part of the Sky Team alliance.

In a federation type of alliance all members give up part of their authority to a super-structure that represents the alliance itself. This structure controls areas like the build-up and commercialization of the alliance brand, network management etc.. Through such a structure the decision making process is speeded up and the power asymmetry between the members is balanced out, reducing the incentive for internal competition and hereby stabilizing the alliance as a whole. Stronger stability in turn gives smaller partners the confidence to specialize, e.g. in providing only feeder traffic to bigger partners. The tight cooperation allows partners to realize higher scale economies on the one hand, but also claim total exclusivity from its members on the other.

At the moment there exists no exclusive example of such a type of alliance, because most independent airlines avoid such strong integration. Looking from a different angle though the early stage of the Air France – KLM merger might count as a federation type alliance, because at the beginning both partners were continued as separate entities to secure international air rights. It was not until two years after the merger announcement when the partners were converted into a single entity, but they had already started merging their operations and other activities.

## 4. Characteristics and Types of Mergers

In contrast to the alliance concept the term merger is more commonly defined and used. Its main characteristic is the loss of legal autonomy. Usually in a merger situation at least one of the partners will have to give up its own autonomy. To transfer the autonomy either all assets of the partner are acquired or a whole new company is established (detailed information about the differences will follow below).

Another characteristic that is unique to the merger concept is the payment of a premium, which clearly distinguishes it from an alliance. A premium is considered to be the amount paid for the target company in addition to its actual share price (Gaughan, 2007) or putting it differently, the amount in addition to its real market value (Tauber, 2008). This premium transfers the right to control the target company and claim all future profits to the buyer (Tauber, 2008). The latter has to be aware that this premium may not exceed expected profits or synergies. Even though this circumstance is known to potential buyers such premiums are often set too high, causing disadvantages for the buyer and its shareholders. Reasons for false estimations are often due to management failure.

Firstly, it is possible that managers do not take into account competitors reactions to the merger, which might reduce future advantages (Gaughan, 2007). Secondly, their valuation of future advantages may be simply too optimistic and thirdly some managers tend to fall for the winners curse. The winners curse occurs when two or more potential buyers compete for the right to purchase a target by trying to outbid one another. In the end one of the competitors “wins” and his offer is accepted, but usually such a contest leaves the final buyer with a higher price than what he would have paid without the bidding contest (Gaughan, 2005).

In the aviation industry horizontal mergers are the types of mergers that can be found exclusively today. In this area at least two occurrences can be observed:

- On the one hand current mergers, where a smaller target company is integrated into a much bigger buyer company, are common. Per definition the target should lose its independence and thereby integrates with the buyer's administration and brand while its own brand ceases to exist (Gaughan, 2005). A good example is the Lufthansa – Swiss merger in mid 2007. Although Lufthansa acquired 100% of Swiss shares it agreed to preserve the Swiss brand, as well as remaining headquarters in Switzerland. Despite this agreement operations and the Zurich hub were completely integrated into Lufthansa's network giving Swiss only a feeder role (Iatrou & Oretti, 2007).
- On the other hand merger of equals are starting to become easier because of ongoing deregulation. In this case merger partners are of a similar size and mostly direct competitors. Instead of integrating one into the other, the partners tend to form a completely new company and brand resulting in the abandonment of the old brands. Furthermore, acquiring the assets of the partner company is replaced by the exchange of shares (Gaughan, 2005). In essence this was done during the merger of Air France and KLM simply emerging from the process as Air France – KLM. Yet this case diverges from theory, because the partners have not integrated their companies completely. It can be observed that both partners continue to operate their own hubs and services and they still manage their own brands. Their cooperation is therefore mainly limited to code share, harmonization of flight plans and optimization of common management revenues (Iatrou & Oretti, 2007). Whether this cooperation might be called a merger from an economic point of view is discussible, but from a legal point of view it needs to be categorized as such.

Having introduced the theoretic concepts of mergers and alliances the next chapter will compare these two forms of cooperation in relation to the airline industry and their ability to generate synergies in several areas.

## 5. Comparing the Alliance and Merger Concept in the Passenger Aviation Industry

In the following sub chapters it is envisaged to compare the alliance and merger concept by looking into their ability to generate synergies for airlines. To begin with it is analyzed what kind of synergies can be generated by today's airline cooperations and whether they develop these in different degrees. Afterwards the ability to realize synergies will be analyzed in detail by looking into the following areas of the passenger aviation industry:

- Market entry and network expansion
- Network integration
- Joint procurement and labour costs
- Frequent Flyer Programs
- Identity and integration

## 5.1 Synergies

Both alliances and mergers seem to fulfil a similar goal by combining complementary abilities to achieve strategic goals (Swaler, 2005). In principle the objective targets are similar; therefore they can be roughly outlined as follows:

- Supply
  - Access to new technologies, resources and markets
  - Strengthening of bargaining power
- Production
  - Realisation of scale economies through efficient use of production factors
- Distribution
  - Cost reduction through joint marketing, logistics etc.

(Balling 1998, Sawler 2005)

To reach these goals both forms of cooperation try to use their abilities to realize economies of scale, scope and density.

At this, airlines are most likely to generate scale economies by increasing the size of their fleet. One drawback of fleet extension is that significant advantages were only found up to a fleet size of 20 aircraft. Therefore, only smaller airlines would actually benefit from such an extension. The reason for this circumstance is the nature of the product “flight” itself, since it cannot be produced in a special place, it is labour intensive and it cannot be stored. Another limitation for scale economics is the fact that only 50% of total operating costs of an airline are variable costs, meaning that the spreading of fixed costs over an increasing amount of output is capped (Kleymann & Seristö, 2004). Moreover, economies of scope are usually generated by raising the number of product variations. An airline might achieve this by extending their destination network through code sharing, a common brand name or a Frequent Flyer Program (FFP). Finally, economies of density can be achieved by increasing load factors. This is achieved by either increasing the load factor on a specific route by using bigger aircrafts or for the whole network, for example by optimising feeder traffic or harmonizing flight plans (Kleymann & Seristö, 2004).

For being able to compare alliances and mergers in more detail it is important to break down the terms of synergies even further and to analyse how they can be separated in revenue increasing and cost reducing synergies. From theory it is found that mergers are more likely to generate cost reducing synergies. Because of their deep integration the partners are able to eliminate overlapping business areas or assign a feeder role to one of the partners more easily, resulting in an optimization of the company as a whole (Gaughan, 2005). Furthermore, the management usually prefers these kinds of synergies, because they can be counted and measured, hence making it easier to integrate them into evaluation models (Gaughan, 2007).

Alliances on the other hand are less integrated limiting their ability to reduce costs by eliminating

double work etc. (Iatrou & Oretti, 2005). Instead, alliances are able to increase their common revenue by using code share agreements to harmonise their combined flight plans (Vasigh, Fleming, Tacker, 2008). Besides, additional traffic can also be generated by choosing a partner whose network is significantly different from the own.

However it is clear that revenue enhancing as well as cost reducing synergies will eventually reach their limit and airlines will have to find other ways to realize synergies. Especially airline alliances will sooner or later have to rethink their abilities to reduce costs (Iatrou & Alamdari, 2005).

## **5.2 Synergies in the passenger aviation market**

While the previous chapter had a more general focus in the following chapters a more detailed view is used to analyse those areas of the passenger aviation market which predominantly tend to generate synergies.

### **5.2.1 Market Entry & Network Expansion**

Especially in the aviation industry being present on as many markets as possible is an essential advantage over competitors. Though a huge variety of destinations is a quality issue requested by costumers it is not always possible for airlines to comply with this request due to national law. In the EU for example alliances and mergers have to be approved by the European Commission. In the US the responsible government body is the Department of Transport. For mergers the limitations on an international level are even more severe than for alliances, e.g. a non-American airline is not allowed to purchase more than 49% of ownership shares and no more than 25% of voting rights in an American carrier. Hence, non-American shareholders are not able to execute any kind of control over an American carrier (Hofer & Dresner, 2007; Pilarsky, 2007).

Despite legal barriers there are other insecurities that have to be taken into account before entering a new market. Of course such an attempt is always risky, but the risk increases when the company has no experience in that particular new market. No or incomplete information about consumer and rival behaviour are likely to cause the entry to fail. Even if a company is successful in its home market it might not be able to deploy its current strategy to another geographic region or culture. To reduce the risk of failure, cooperation with an experienced and successful local company is a good way. Especially if the new market is located further away from the home market in geographical terms and cultures differ strongly an alliance might be the preferred option, because the inexperience of the buyer might cause high integration costs in case of a merger. In the above case even within an alliance it might be wiser to leave the management of the cooperation to the local partner as well (Reuer, 2004).

A second scenario would be that experience in the new market already exists. In such a case on the one hand the integration costs in a merger case would be significantly lower. On the other hand the existence of experience indicates that the company has already been active in that market, so the term market entry may not be fully appropriate here. Furthermore, Doukas & Travos (1988) found out that a merger usually generates positive scale economies only if the buyer has not been active in the market of its partner before. If the buyer already has experience in the new market a merger is likely to generate no or even negative scale economies. This is due to the fact that the buyer has already gathered most of the benefits possible through its earlier activities in the new market.

Therefore it is questionable whether a merger with a competitor can really strengthen the competitive position of the buyer as much as it hoped to (Doukas & Travos, 1988).

From an airline's point of view entering a new market basically means broadening its network, making new destinations available to their customers. The costs of every new city-pair that is to be integrated into a current network will as a result decrease, because in a hub-and-spokes system a multitude of connections can be realized through the addition of only one new city-pair to the overall network (Iatrou & Oretti, 2007). The synergies generated by this effect will rise with the size of the airline's network (Culpan, 2002).

An alliance offers the advantage that partners can form a global network without investing in planes etc. themselves (Iatrou & Skoruias, 2005). A positive effect for customers appears when alliance partners pool their traffic and are therefore able to continue to offer routes which were otherwise unattractive to operate, due to low passenger numbers. While in a merger situation one would expect those routes to be cancelled from the flight plan. The striking difference in this matter is that a merger will increase the airline's network and the company size with it. In contrast, in an alliance situation the size of the company will stay the same even though the network is extended. The question to be raised now is whether it is desirable to increase company size? It is possible that the company already reached the minimum efficient scale. In such a case a merger would move the company away from the profit maximizing output and cause profits to fall (Besanko et al, 2007). Consequently bigger is not always better. As an example Southwest may be consulted since it is neither the biggest nor the most global of airlines, but the most profitable in today's industry (Pilarski, 2007).

### ***5.2.2 Network integration – Code Sharing, Optimization of Flight Plans & Antitrust Immunity***

As shown above entering a new market for an airline does not only mean generating additional passengers by convincing them of the product quality, but also offering more route choices and connections. To be able to offer decent connections it is necessary to integrate the partners' networks and flight plans optimally.

The integration of networks will offer a multitude of advantages, from which some are mentioned below:

- Parallel routes may be operated by only one of the partners, allowing the operating partner to increase its load factor while the other partner is able to save the costs of operation and reroute its freed up resources.
- Parallel routes may however as well be operated together by both partners, allowing the partners to offer higher frequencies to their customers.
- Customers are able to book their flights (with connections) with only one airline, even though the route is physically operated by more than one airline.
- On routes where traffic volumes are low partners can pool their traffic making the route more efficient.

- To harmonize flight plans partners can direct bundled feeder traffic through their hub systems and spread it again across the partners' network. This classical move in a hub and spokes system is affecting the network and routes' load factor positively.

In an approved merger case all the above advantages can be realised and further allow the partners to jointly set prices for code share routes and eliminate double routes (Iatrou & Oretti, 2007). To realize a maximum of cost reducing synergies in this area partners should have a large share of overlapping routes in their network, enabling the partners to merge a significant amount of traffic (Doganis, 2001).

Following theory, an alliance should in contrast be formed between partners whose networks have as little overlap as possible to increase revenue enhancing synergies (Vasig et al, 2008). For the processes of network integration alliance partners have to use the code sharing method, but code sharing is only half the story. While code sharing allows alliance partners to integrate their networks to a certain extent it doesn't allow them to set a common price for the entire route. This means every partner has to set a price for the portion of the route they operate independently and finally add these up to an overall route price. As a result double marginalisation occurs, raising the price over those of competitors, causing passenger numbers to decline (Iatrou & Oretti, 2007). To eliminate this risk alliances have to apply for antitrust immunity with the respective national authority. Only then they are allowed to cooperate in setting prices as well.

Further harmonization of the common network can be achieved by allocating a feeder role to a smaller partner inside the network. This strategy usually works best in a merger where the target company is far smaller than the buyer. In this situation the buyer is able to assign the company to a feeder role. Are the partners of the same size though, most decisions have to be made together making it very complicated to convince one of the partners to take a feeder role by choice. The same thing is true for alliance partners even if they are of different size, due to their legal and economic independence. It takes strong trust and a high level of integration among the alliance partners for a smaller partner to accept a pure feeder role (Vasig et al, 2008).

### ***5.2.3 Joint Procurement & Labour Costs***

Joint procurement allows the partners to increase the volume they intend to buy from their suppliers. A greater product volume results in higher bargaining power for the cooperation to negotiate special deals and discounts. The deeper the integration between the partners the higher will be the potential synergies generated by it. In the aviation industry the greatest potential for joint procurement can be found in the purchase of fuel and aircraft.

These potentials seem to be limited for alliance partners mirrored by their level of integration. At the moment alliances cooperate mainly in the areas of office supply, non-branded spare parts and fuel. Thus, the most efficient area for joint procurement, namely buying aircraft, is still left out. Additional potential can also be found in the pooling of sales stations, ground handling, maintenance facilities, reservation- and ticket counters and marketing in the alliance hubs (Iatrou & Oretti, 2007). According to a study by Gemini Consulting and Airline Business the cooperation in the aforementioned areas could account for around 3.6% of total costs for the partners (Airline Business, 2001). A stronger cooperation in these areas might be worth considering for airlines.

In theory for a merger realizing joint procurement should be a lot easier, but the reality looks different. To run joint procurement successfully alliance and merger partners need to agree on standards for technical equipment and interior designs. This is equally difficult, because alliance partners tend to try and protect their own brand to a certain extent and merger partners face the challenge of integrating their different systems. Taking the fleet structure as an example, to generate maximum synergies theoretically the merging partners would have to replace the entire fleet or at least parts of it and implement a common standard. The costs for such an attempt would be enormous and therefore mostly inefficient. Instead, merger partners try to align their fleets over a longer period of time, a so called phasing-out. If an aircraft needs to be replaced it is substituted by a common standard aircraft. The downside of phasing-out is its duration; it can take weeks, month or even years to be completed reducing the synergies generated by joint procurement or at least postponing them into the far future.

Another potential area for cost reductions are labour costs. In the US market labour costs can make up for over 40% and in the EU up to 35% of total costs of an airline (Doganis, 2002), making labour costs worth looking into. Again, in theory merger partners have the possibility to dismiss employees by eliminating double departments etc., but in reality these savings are likely to be reduced or even consumed by pay-offs and social security costs (Vogel, 2002). Alliance partners on the other hand may want to try to outsource certain activities to a partner, who is bound to lower pay rates due to its nationality. Another alternative is the employment of cheaper workers directly from a partner airline instead of using one's own, more expensive staff (Iatrou & Oretti, 2007). What has to be kept in mind though is that all these options to reduce labour costs either for alliances or mergers are usually accompanied by massive resistance from labour unions and politicians, causing cooperation talks to be more time consuming and complicated than often expected. In the worst case they can even cause them to be abandoned.

#### ***5.2.4 Frequent Flyer Programs***

Frequent Flyer Programs (FFPs) allow passengers to collect points every time they fly with a certain airline or alliance. These points can be redeemed for bonuses e.g. free flights (Iatrou & Oretti, 2007). These benefits are meant to bind the passenger to a certain airline or airline cooperation by increasing its costs of switching and thereby preventing a switch in the first place (Hüschelrath, 2005). In theory FFPs are therefore expected to enable airlines to keep their current passengers and attract new ones, causing the airlines load factors and revenues to increase alongside. One important advantage is the size of the network, because the wider the network covered by the FFP, the higher the attractiveness of the FFP for potential customers (Iatrou & Oretti, 2007). The overall problem of FFPs however is their multiplicity. Almost every airline or airline cooperation does not only have their own FFP, but is also entangled in one or more alliance FFPs. Furthermore, the conditions for redeeming points may differ between the FFPs or they differ in the range of their offered services (Iatrou & Oretti, 2007). It is therefore questionable whether FFPs really generate considerable synergies due to the various entanglements and conditions.

#### ***5.2.5 Identity and Integration***

In today's aviation industry the identity of an airline still seems to be important at least for the airline itself. Especially in alliances carriers offering a higher quality and/ or extended services fear that partners with lower quality for example may damage their own image and drive away customers

(Iatrou & Oretti, 2007). Theoretically this shouldn't be a problem for merger partners at all, because usually smaller targets adopt the brand of the buyer and in the case of a merger of equals a new brand is established. Yet several examples in the aviation industry show a different picture and intend that also in merger cases, no matter of the size of partners, the brand of an airline is considered of great importance and needs to be preserved (Gaughan, 2005). Keeping on to their respective identities or brands makes the integration process of both cooperation forms even more difficult.

The phase of integration is the most difficult part of a cooperation process. Overall more than 50% of mergers (Gerds & Schewe, 2005) and around 40% of alliances (Lucks, 2005) fail at this point. The reasons for failure are manifold, but the most common ones are the following:

- Partners fail to formulate specific and agreed common goals for the cooperation causing individual goals to become contradictory (Balling, 1998).
- Partners fail to reach an agreement on the allocation of duties and distribution of costs and revenues for collective activities between the partners (Balling, 1998).
- Especially in merger situations it is possible that employees reject the merger, because they are uncertain about their future situation. Fear of losing one's job and other uncertainties may cause a higher number of staff away sick, resignations or strikes (Vogel, 2002).

Sometimes the origin of the above problems in a merger case lay with the management. It is possible that a manager pushes forward a merger even though this might not be the best option for the company. An explanation for such an irrational behaviour is given by the hubris theory. According to this managers may tend to support a merger, because they overestimate the value of the target, their wages are linked to the company size or bonus payments are promised in the case of a merger (Gaughan, 2005). An alliance offers the possibility to eliminate most of the problems mentioned above, because the integration process is done in smaller steps than in a merger. With this softer approach cultural and operative shocks can be reduced and the independence of the alliance partners avoids massive changes in terms of e.g. lay-offs (Chang & HSU, 2005). A far bigger challenge for the alliance is the integration of their IT-systems. This causes the highest costs and is very time intensive, but essential for providing seamless travel, e.g. e-ticketing (Vasig et al., 2008).

## 6. Conclusion and Reality

The previous chapters shed some light onto the theoretical options for alliances and mergers in general and in the aviation industry in particular. It was analysed under what circumstances one or the other form of cooperation might generate synergies. This closing chapter now concludes the findings and compares them with real life examples in today's airline alliances and mergers.

First of all it was shown that alliances and mergers follow strategically very similar goals but differ significantly in their implementation. While mergers are more laid out for handling current problems the aim of a strategic alliance is to secure the competitive position against future competitors. While an alliance shows its effects mainly in future competition, the effects of a merger should be visible in real time (Basedow & Jung, 1993).

With the beginning of the year 2008 the aviation industry saw a steep increase in merger talks and alliance activities between airlines. Especially in Europe several mergers were initiated:

- The Italian government tried to sell its share of Alitalia
- British Airways finally merged with Iberia<sup>6</sup>, but ended merger talks with Qantas
- Lufthansa buys Brussels Airlines, Austrian Airlines (AUA) and BMI
- Northwest Airlines merges with Delta Airlines

Yet, in the alliance environment activities increased as well:

- Continental Airlines switched to Star Alliance in 2009
- Air France-KLM and Delta-Northwest received antitrust immunity
- British Airways and American Airlines apply for antitrust immunity
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How do these activities contribute now to the theoretical findings?

As theory states, on the one hand entering a market where the company lacks experience is costly, but there are more potential synergies to exploit. On the other hand, entering a market the company already collected experience in is less costly, but offers far less potential synergies. By looking into the recent merger activities in the aviation industry the question as to their reasons arises. In the case of Lufthansa – AUA, BA – Iberia and Northwest – Delta all carriers maintained an alliance for several years before deciding to merge. This circumstance initiates that most potential synergies in this area should have been exploited by now. Also, the fact that in the Lufthansa – AUA case synergies were additionally limited through conditions such as preserving the AUA brand and its headquarters and arbitrament in Austria (Airline Business, 2008). It seems that at least in Europe the reason for this “merger mania” is more due to increased competition between Air France-KLM, BA and Lufthansa over the dominance in the European market. Obviously, these carriers try to secure the networks of their alliance partners by acquiring them and thereby making them inaccessible to competitors. To assess the potential synergies arising from such a move may be the outcome of losing the corresponding partnership should be considered in more detail in future research.

Securing the overall partner’s network to realize a maximum of synergies, however, is only half the story. The next important step is to harmonize flight plans. How important this step really is can be shown by a detailed look into the Washington – Frankfurt route operated by Lufthansa and United in the Star Alliance. Iatrou & Oretti (2007) show that half of United’s passengers fly only between Washington and Frankfurt while the other half uses one or even both hubs as a connection point to reach destinations further in the partners’ networks. The same is to be found true for Lufthansa passengers where 73% are actually connecting and only 26% are hub to hub route passengers. In this context a study by Bilotkach (2007) confirms that an alliance without antitrust immunity (on routes

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<sup>6</sup> coming into effect by end of 2010.

with at least one hub connection) generates a higher quality, but also a higher price than a scenario where there is no cooperation between the airlines at all. These findings indicate that the level of double marginalisation is even higher with cooperation than without it. BA and American repeated efforts to gain antitrust immunity may show that its absence constitutes a strong disadvantage for the alliance partners making it impossible for them to exploit all potential synergies.

Up to this point it was argued that potential synergies mainly helped to raise revenues. When cost reductions are targeted the highest potential synergies are provided in the areas of joint procurement and labour costs. As mentioned in the previous chapters the ability of alliances to exploit synergies in the field of joint procurement is limited due to incomplete integration. Despite the limitations, alliance partners often start by cooperating in the field of fuel to push prices down. The Star Alliance for example formed a common company for this purpose, the Star Fuel Co. which was able to cut down fuel costs by US\$ 50 mil. (Vasigh et al, 2008). Adding cost reductions from other fields than fuel the Star Alliance managed to save their partners US\$ 150 mil. p.a. by joint procurement. At first sight this may sound like a huge success, but at a closer look these US\$ 150 mil make up only 0.1% of the alliance's total costs (O'Tool & Gill, 2000). Also merger partners have to consider a time lag for synergies to show effectively, because of the phasing out effect. Joint procurement therefore still holds a huge potential for cost reductions if airlines decide to move deeper in integration.

Moreover, in chapter 5 it was found that bringing down labour costs is another possible way to reduce overall costs of airline cooperations, but that it can be seriously influenced by politics and labour unions. Lufthansa for example was pressured by politics to agree on sustaining the AUA and Brussels brand to be able to close the deals. Besides, labour unions in Italy proved their power by putting so much pressure on KLM that it withdraw its bid for Alitalia in 2008 (The Economist, 2008). The implementation of joint procurement and reduction of labour costs therefore seems to be a time consuming and uncertain process for alliance as well as merger partners.

Furthermore in theory FFPs help airlines to keep on to existing passengers and win new ones, but in reality the multiplicity of FFPs and their massive entanglement show that making a choice between all the different FFPs is not easy for the customer. Furthermore, the integration of the required IT systems is a complicated process that takes time for both forms of cooperation. To give an example, Air France-KLM needed more than two years to affiliate their data bases and design the Flying Blue brand for their common FFP (Iatrou & Oretti, 2007). This does not include the process of aligning it with the Sky Team FFP or the FFP of other Sky Team partners. Synergies coming from this area of cooperation therefore will not occur promptly.

Finally it has been observed that alliance and merger partners respectively tend to hold on very strongly to their identity. Alliance members are worried about their own image when compared to their partners while merger partners seem to take their identities as an asset value. The latter might be questionable, because the national pride passengers took in their carriers has given way to the variety of destinations, frequencies and prices (Vasigh et al.,2008). Nonetheless holding on to their identities is causing the integration process to become even more complicated and uncertain for both forms of cooperation than it already is. If the integration phase is not planned and executed properly potential synergies form following areas of integration may be exploited only in lesser amounts or far later than expected and calculated by the partners. If integration fails completely there will be no synergies to be gained, but high amount of already paid costs to integration will be lost.

All these findings indicate that the reality of airline alliances and mergers in today's aviation industry do not correspond to the theory very well, leaving huge amounts of potential synergies unused. The key issue seems to be the degree of integration. To be able to unlock unused synergies mutual trust and the willingness to give up part of the own autonomy is an essential step that has to be taken.

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