

Mergers and Acquisitions

Istanbul Technical University

Air Transportation Management, M.Sc. Program

Aviation Economics and Financial Analysis

Module 9

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Outline

- Introduction
- Mergers and Acquisitions (M&A)
- Process and Issues

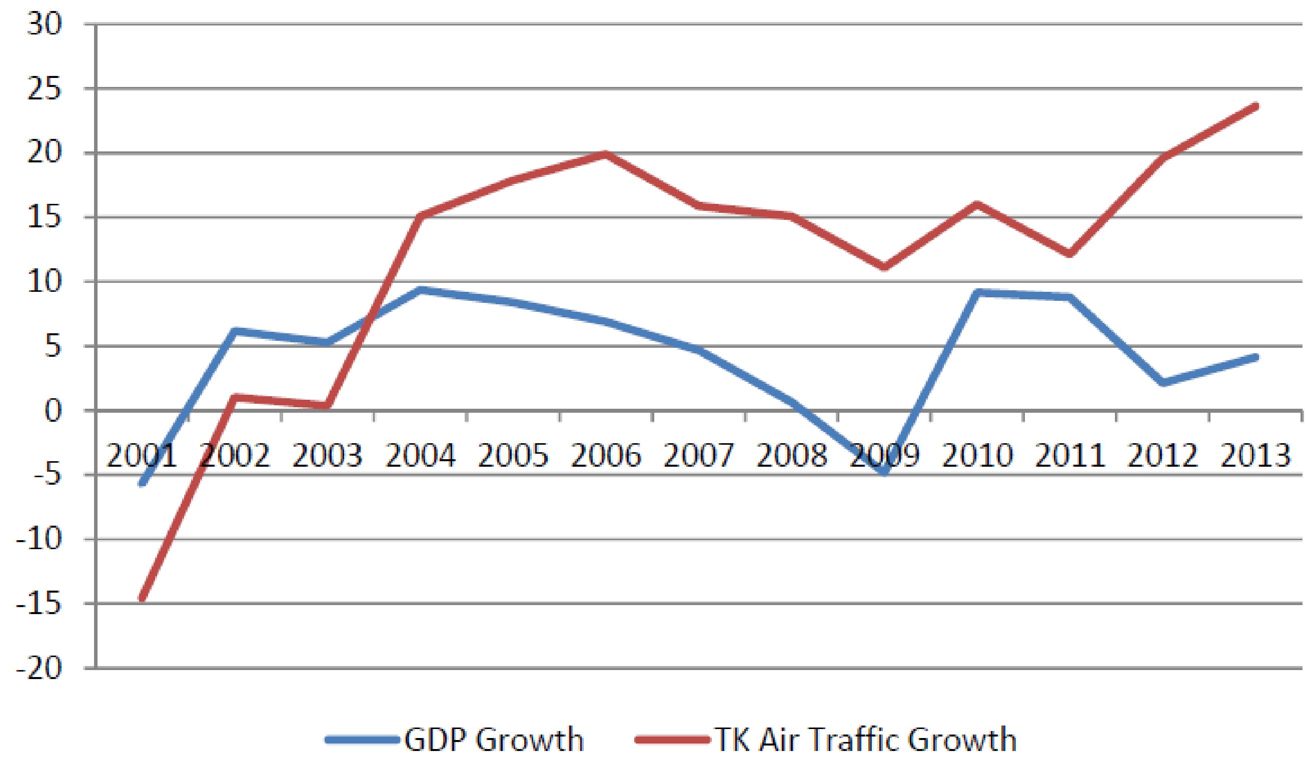
Introduction



Turkish Airline Strategy

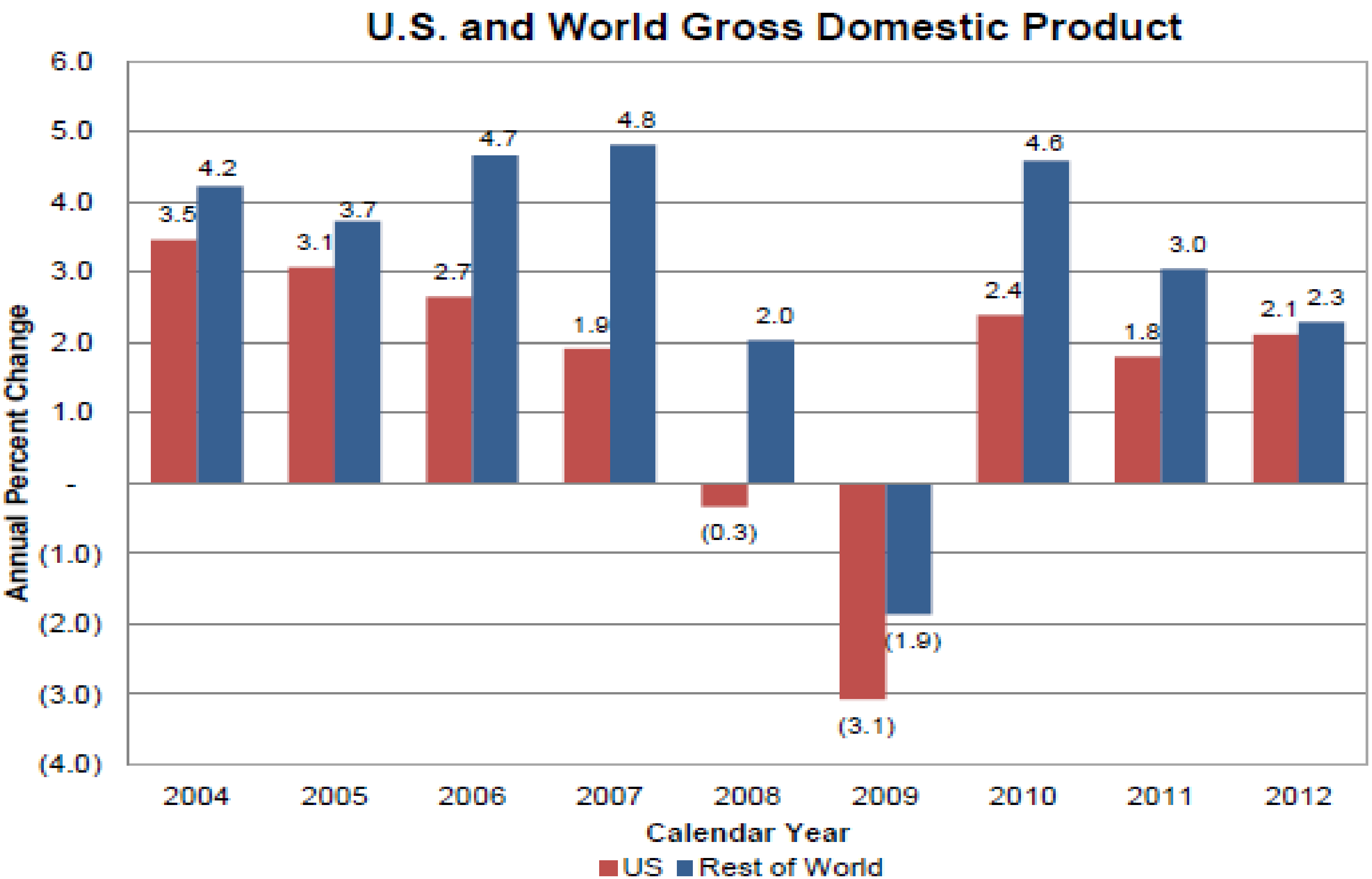
- **The airline industry is cyclical and its performance is closely linked to the gross domestic product (GDP).**

Figure 1: GDP Growth and TK Air Traffic Growth



Source : TUIK and Turkish Airlines Annual Reports

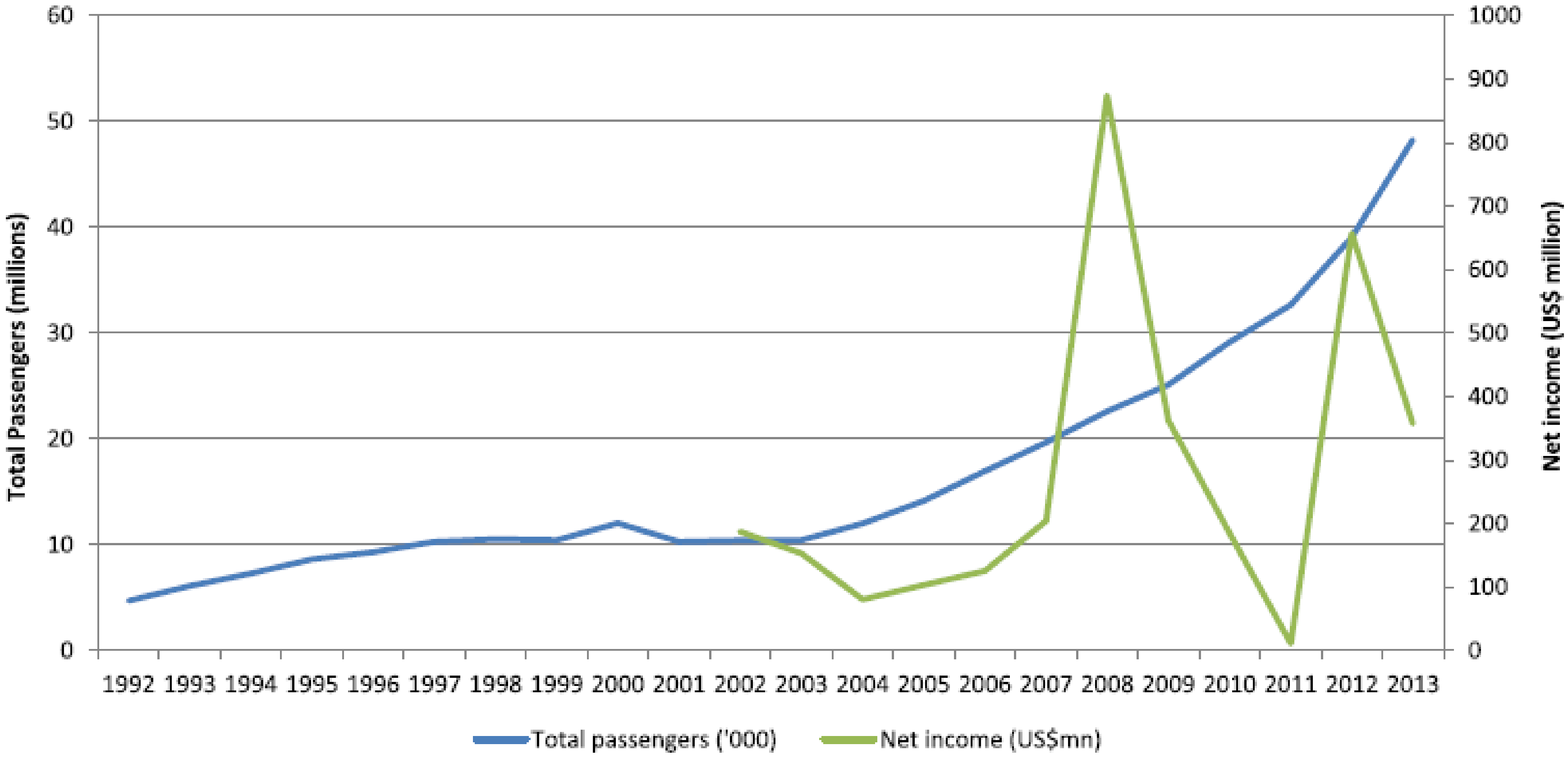
US and World's GDP 2004-2012



Source: IHS Global Insight, GDP Components Tables (Interim Forecast, Monthly), Release date 23

Turkish Airlines Strategy

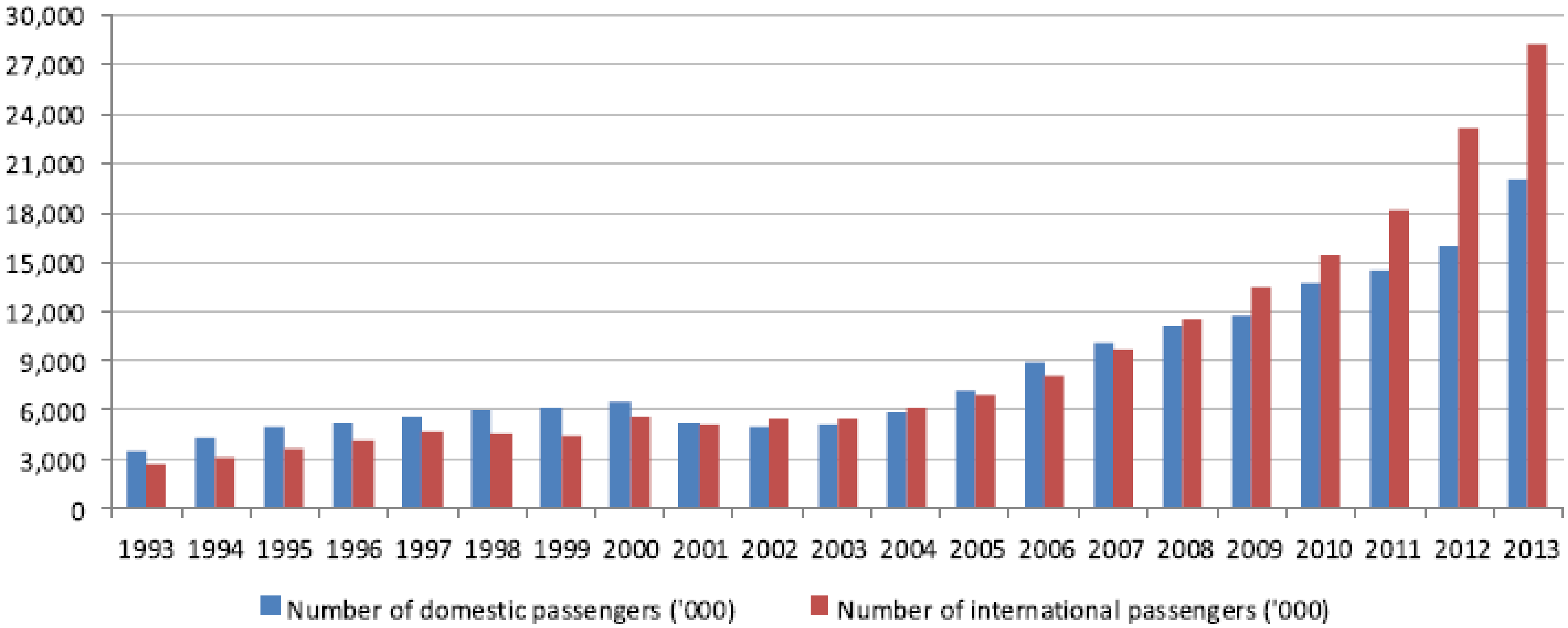
Figure 2: Turkish Airlines Total Passengers and Net Income



Turkish Airlines Strategy

- **Competitive Cost Structure**

Figure 3: Network Development of Turkish Airlines



Turkish Airlines Strategy

- **Geographic Location**

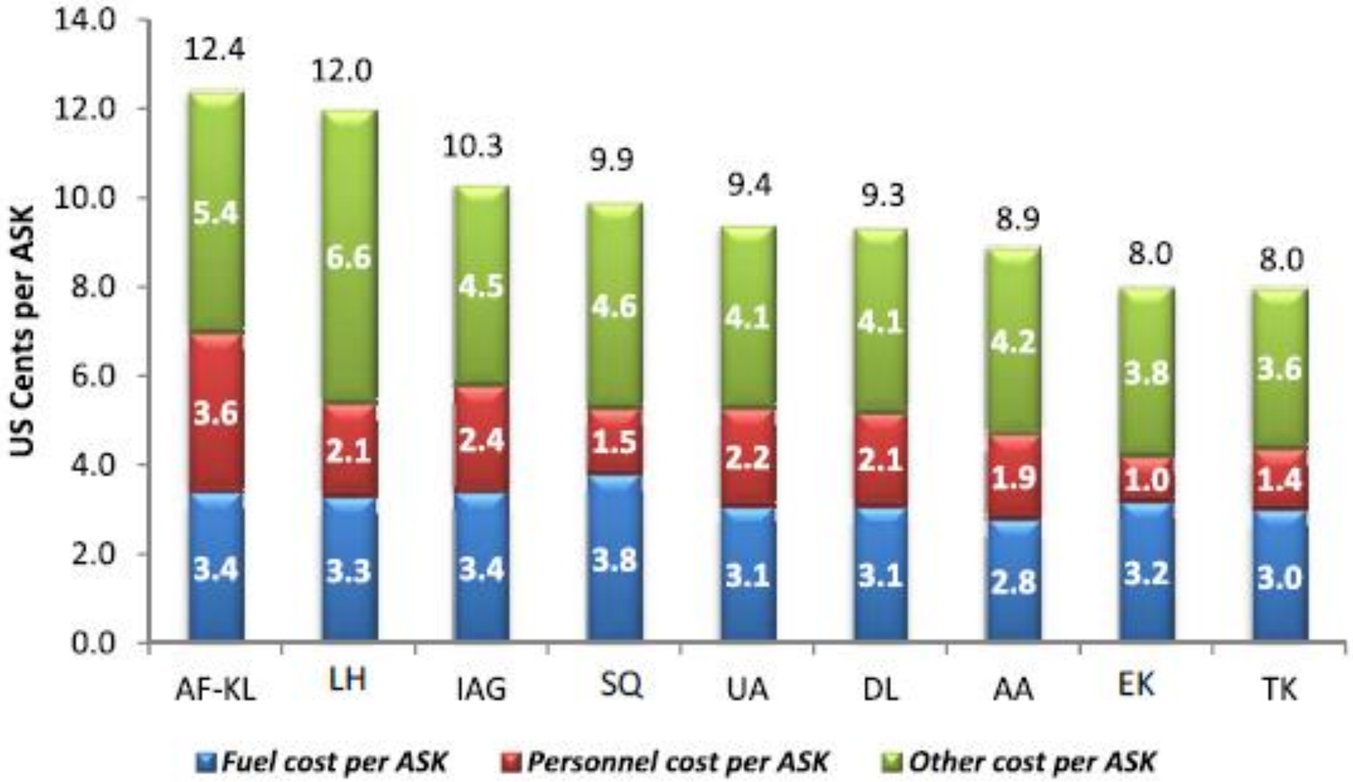
Figure 4: Global Economic Center of Gravity (from 1971 to 2031)

Source: Turkish Airlines from Airbus Global Market Forecast (2012-2031)

Turkish Airlines Strategy

- **Competitive Cost Structure of Turkish Airlines**

Figure 5: The unit costs of selected airlines (2013 Airlines' Annual Reports)



Realizing the vision together

Airline Cooperation and Consolidation

- Aviation is a fast changing world
    - Ethiad has teamed with Air France/KLM.
    - Qatar Airways is now firmly part of Oneworld
    - Rumors: Emirates and Lufthansa are talking
- Turkish has chosen to not use mergers as a strategy, and only uses weak alliances
    - TK could change strategy
    - Future success is highly dependent on negotiationg new bilateral rights to further expand its hub network

Many forms of cooperation possible

- Code-sharing agreements between two airlines
- Membership in global airline alliances
- Joint ventures to share both revenues and costs
- Mergers and acquisitions

InterVISTAS
AVIATION TRANSPORTATION TOURISM

TURKISH AVIATION ACADEMY

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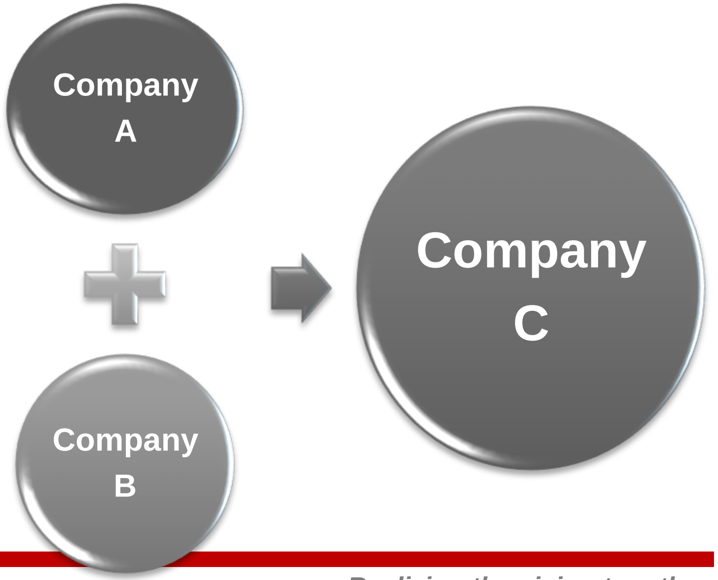
Mergers and Acquisitions

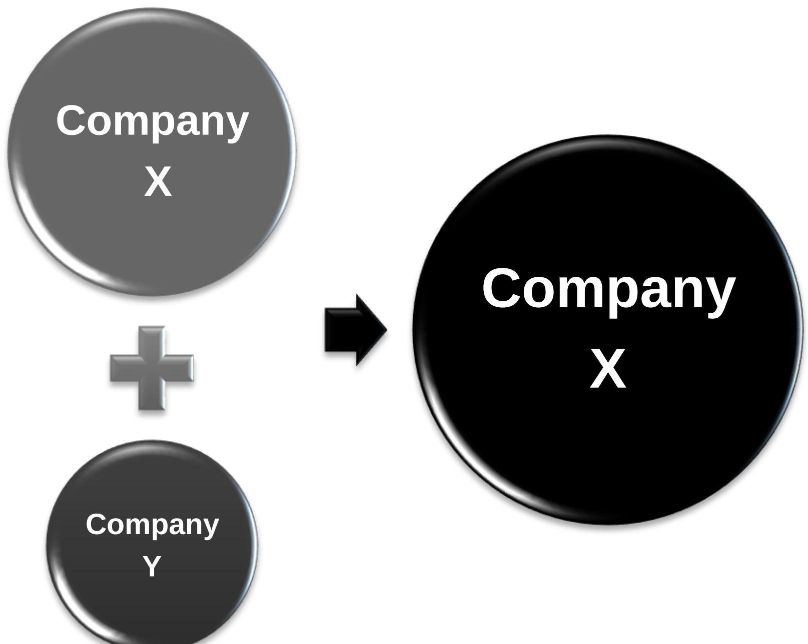
Mergers and Acquisitions

- **Merger:**
  - is where two companies come together to combine and share resources to achieve a common objectives
- **Under merger the combining firms remain**
  - Joint owners
  - New company is created



Mergers and Acquisitions

- **Takeover or Acquisition:**
  - one firm purchase the assets of another, with the acquired firm ceasing to be the owners of the firm. Often it is the larger company which acquires a smaller one.



Types of M&A

- **Horizontal**
  - Two companies engaged in similar activities are combined.
- **Vertical**
  - Firms from different point in the same production process to combine
- **Conglomerate**
  - Occurs when two businesses in unrelated industries decide to combine

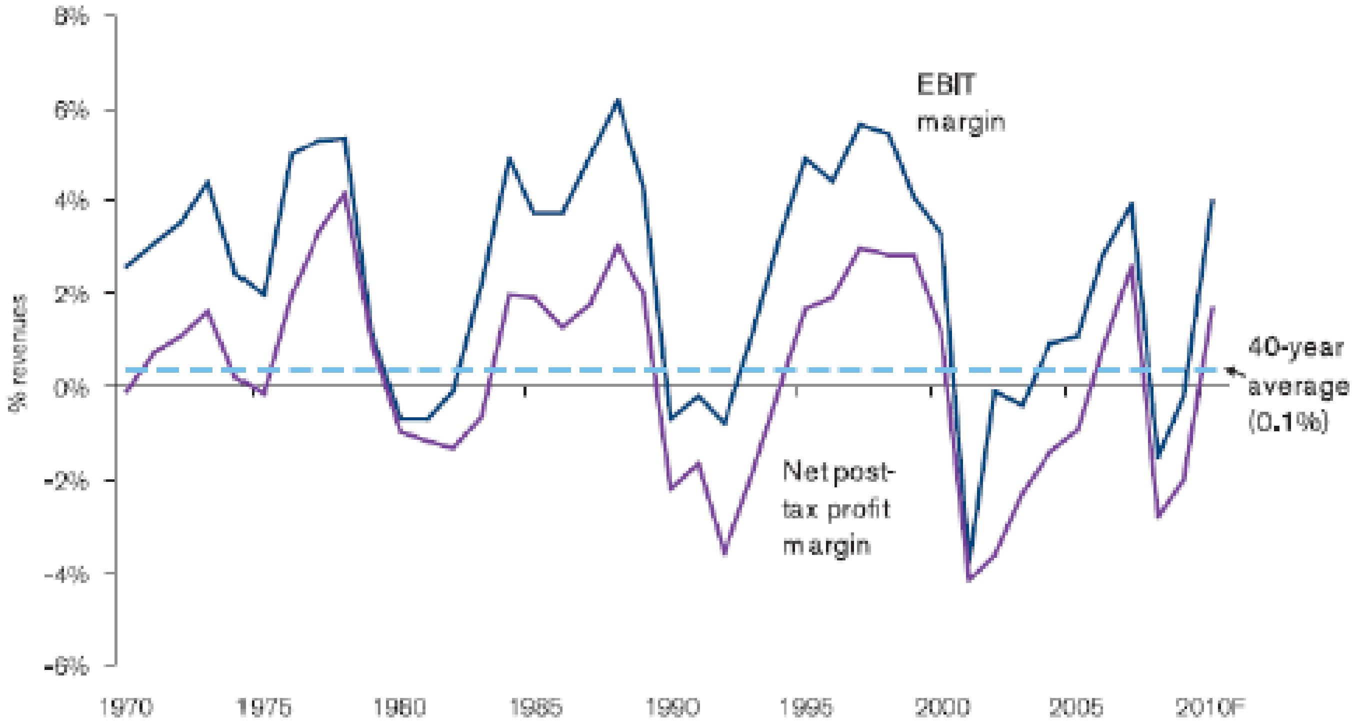
Gains from M&A

- **Increase market power**
  - To have access to another network
  - Value creation by exploiting collusive synergies
- **Operational gains**
  - Reducing operational cost by synergy effects
- **Economies of Scale**
  - To enable benefits of scale to be achieved
  - Better contracts with suppliers

Factors Affecting M&A Activity of Airlines

- **Airline industry is a challenging industry with low profit margins and high volatility of returns**

Figure 6: EBIT margin and Net post-tax profit margin



Source: ICAO and IATA

Factors Affecting M&A Activity of Airlines

- **What was happening on TK side?**

Table 2: TK Airlines summary profit and loss account (USD million): 2009-2013, 1H2013-1H2014

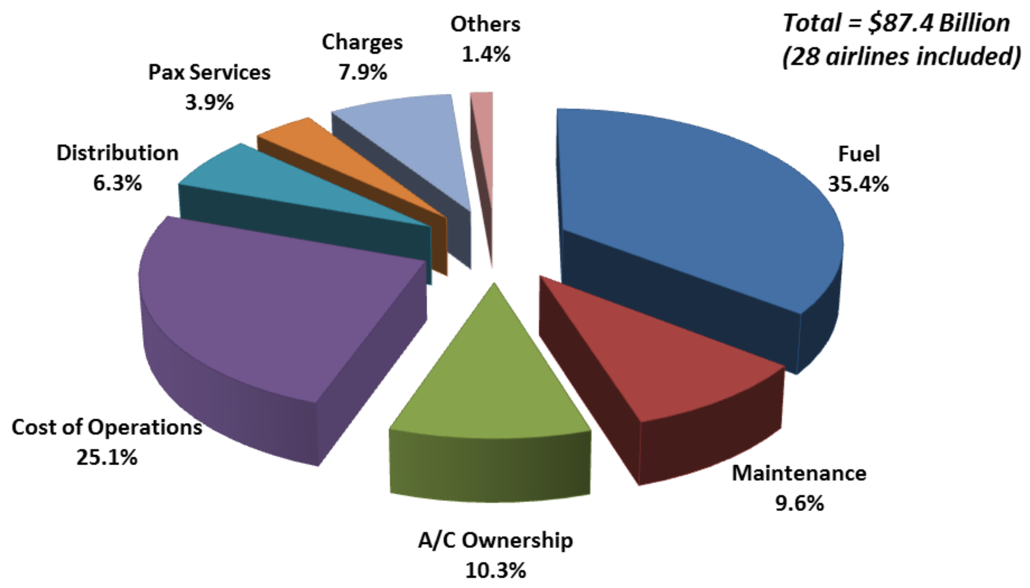
Income Statement (million USD)	2009	2010	2011	2012	2013	1Q2013	1Q2014	13/12 Change
Operating Revenue	4552	5488	7070	8234	9826	2015	2315	19%
Operating Expenses (-)	4058	5149	6855	7616	9249	2062	2418	21%
Operating Profit	494	299	215	618	577	-48	-102	-6.6%
Net Profit	362	185	11	657	357	-14	-102	-45.6%
Net profit % of Revenue	7.9%	3.4%	0.15%	7.9%	3.6%			

Source: Turkish Airlines

Factors Affecting M&A Activity of Airlines

- **Operating costs keep surging**
  - The industry is facing higher operating costs, in particular due to increases in fuel costs which currently account for 25-40% of airline operating osts

Figure 7: Main Cost Divers (2012 Operational Cost Structure)

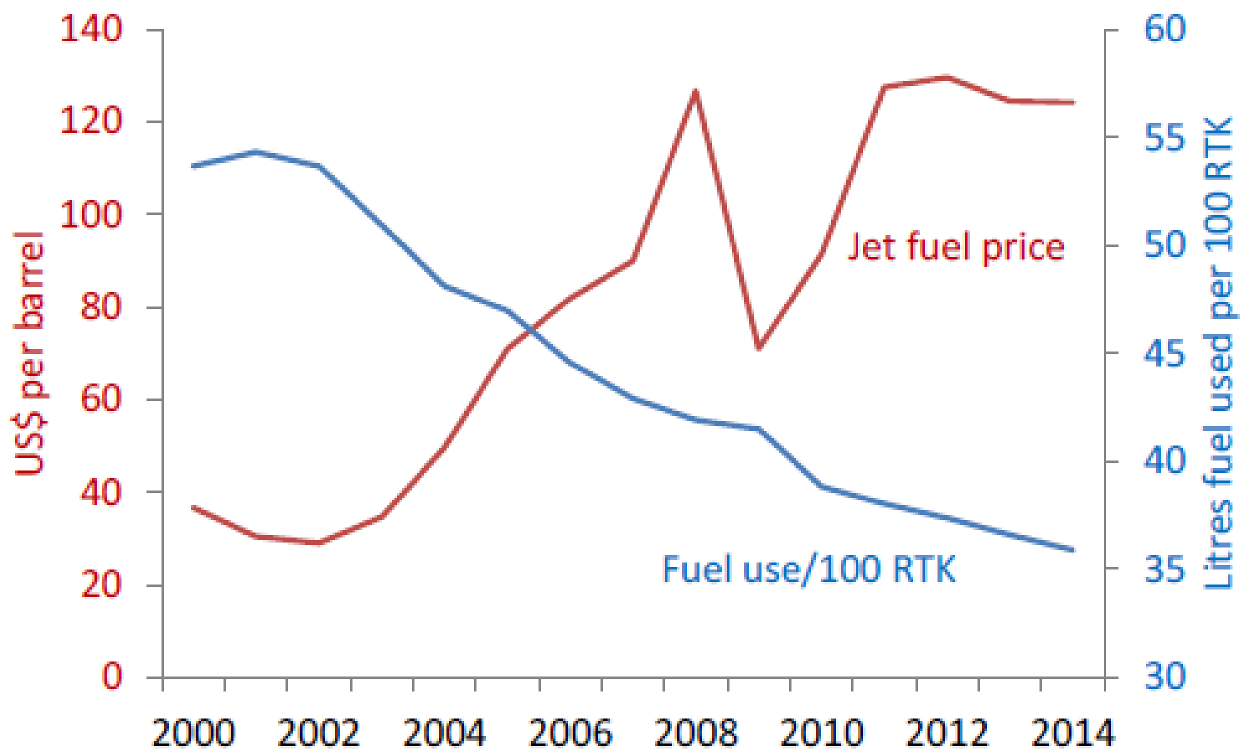


Source: IATA

Factors Affecting M&A Activity of Airlines

- **Saving fuel costs**

Figure 8: Fuel efficiency and the price of jet fuel



Source: IATA, IEA, Platts

Factors Affecting M&A Activity of Airlines

- **Bankruptcies**
  - Cost advantage due to economics of scale and scope
  - Higher demand due to better connectivity, greater range of destinations and increased service frequenct
- **High incidence of bankruptcies in the airline industry following deregulation**
  - Continuing trend among major carriers to restructure under bankruptcy protection in the US

Mergers and Acquisitions (M&A)

- **Mergers and acquisitions (M&A) are complex, involving many parties.**
- **Mergers and acquisitions involve many issues, including**
  - Corporate governance.
  - Form of payment.
  - Legal issues.
  - Contractual issues.
  - Regulatory approval.
- **M&A analysis requires the application of valuation tools to evaluate the M&A decision.**

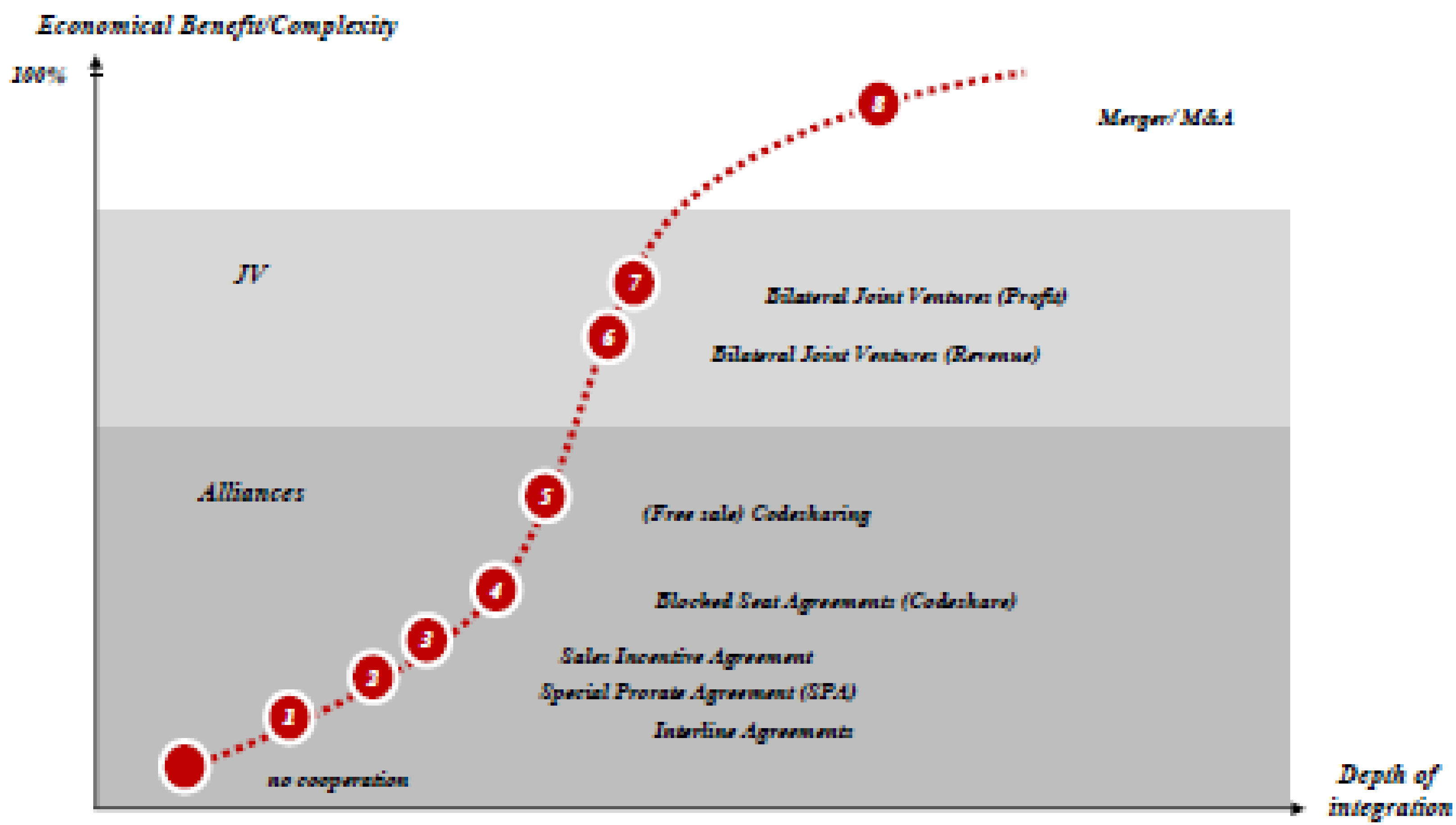
Country	Limits on foreign ownership
Australia-New Zealand	49% for airlines engaged in international operations, 100% for solely domestic
Canada, Mexico	25%
China	35%
Chile	100% as long as airline’s principle place of business is in Chile
EU	49%, applies to non-EU citizens
India	49%, but foreign airlines cannot hold shares in Indian airlines
Japan, Taiwan	33.33%
Korea	49%
Malaysia	45%
Singapore	27.51%
Thailand	30%
United States	25%, one-third of the board of directors, chairman/woman, CEO/president must be US national
Turkey	Majority of the shares must be hold by Turkish national

InterVISTAS

What is alliances

- **An alliance is an agreement (both vertical and horizontal) between two or more airlines that enter into a form of cooperation and may be passenger and/or cargo**
    - Global alliances (Star, SkyTeam and Oneworld)
    - Bilateral and multilateral alliances (marketing alliances, joint ventures, code share, etc.)
- **Alliances are subject to regulatory approval depending on its integration level**
    - US regulators may grant anti-trust immunity to international alliances
    - EU regulators may grant anti-trust immunity to international alliances
    - Both the US and EU will consider whether or not there is a signed Open Skies Agreement with the foreign carrier’s government

Airline Cooperation



Metal-neutral Joint Ventures

- **Metal-neutral joint ventures**
  - High degree of integration
  - The most intensive form of an airline alliance
  - Revenue & profit sharing
  - Joint setting of prices and schedules
  - Similar to a merger but no ownership transfer
- **Metal-neutral joint ventures in major aviation markets**
  - Transatlantic
    - Star A++ (Lufthansa Group, Air Canada, United/Continental)
    - SkyTeam Joint Venture (Air France / KLM, Delta and Alitalia)
    - Oneworld Joint Venture (American, British Airways / Iberia)
  - Transpacific
    - Star Joint Venture (United / Continental, ANA)
    - Delta/Virgin Australia Joint Venture
    - American / JAL Joint Venture

Why alliances?

- **Foreign ownership rules**
  - Many countries prohibit or limit ownership of domestic airlines. International or cross-border mergers are rare. Instead, the benefits of a merger can be achieved through an alliance.
- **Restrictions on cabotage rights**
  - Countries generally restrict foreign airlines from operating domestic service. There are exceptions (e.g. the European Union, Australia allowing some cabotage as extension of long haul routes).
- **Access to a larger global network**
  - Airlines can increase service frequency and number of destinations served by participating in an alliance. Increased connectivity may improve load factors.

Why alliances?

- **Marketing cooperation**
  - Frequent Flyer Programs
  - Codeshare Agreements
  - Lounge Access
  - etc.
- **Cost synergies**
  - Shared airport facilities
  - Joint scheduling
  - Reciprocal sales arrangements
  - Increased buyer power
- **Decrease in competition**
  - Airline alliances have a potential to diminish or exclude competition.
  - Pro- and anti-competitive effects will be discussed in Module 10.

Trends in airline alliances

- **Many major airlines have joined a major alliance grouping (Star, SkyTeam or Oneworld)**
  - Over 50 carriers are members of one of the three major alliances
  - These carriers represent two-thirds of industry’s ASKs
  - LCCs begin to join global alliances. In 2012, Airberlin joined oneworld
- **There is a tendency towards seeking deeper cooperation by airlines via bilateral and multilateral alliances**
  - “metal neutral” joint ventures are a form of a super-alliance which is very similar to a merger.
- **Several major carrier that have deliberately avoided alliances seek increased cooperation on a bilateral basis (e.g. Emirates, Etihad)**

Process and Issues

InterVISTAS

Etihad's Strategic Partnerships

Realizing the vision together

Air Traffic Paradigm Shifts

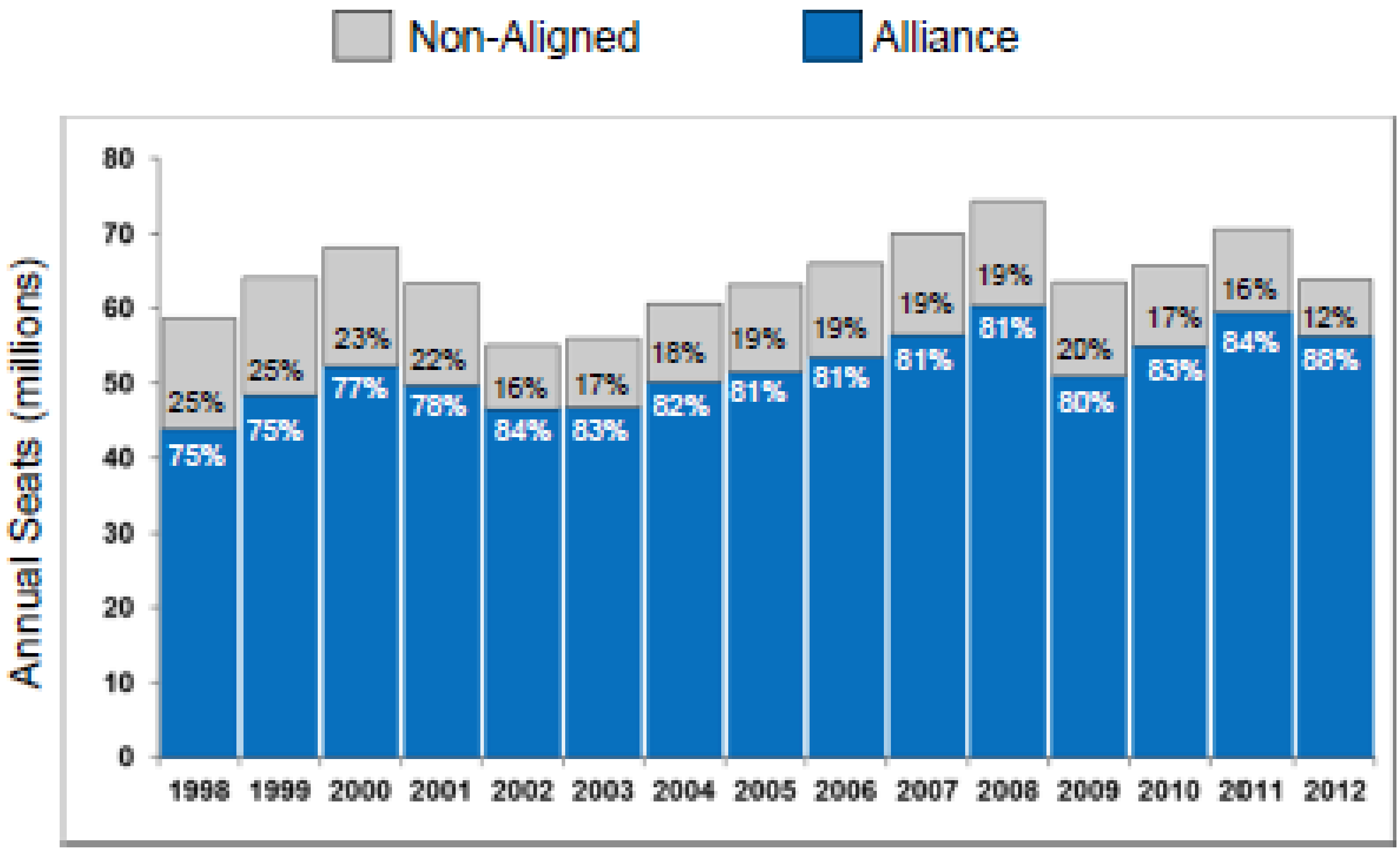
The emergence of Gulf/Middle East carriers has caused a paradigm shift in global traffic flows across major connecting hubs are depicted above.

Qantas and Emirates Partnership

- **Before**
  - Qantas had 5 one-stop destinations in Europe (via QF operations or codeshares)
  - No service to Middle East/North Africa
- **After**
  - 32 once-stop destinations in Europe and 31 one-stop destinations in Middle East/North Africa via DXB
  - Revised service to SIN/HKG/KUL for better connectivity to Asia

Recent M&A and Joint Ventures in the US

North Atlantic Alliance and Non-Aligned Market Shares



Source: U.S. DOT T-100

North Atlantic Alliance Structure

July 2013 Market Shares (Frequency)*

	Joint Venture	Other Alliance	Non-Aligned
U.S. – Europe	78.5%	14.3%	7.2%
U.S. – U.K.	94.5%	3.5%	2.0%
U.S. – London LHR	96.4%	3.1%	0.4%
U.S. – Paris CDG	90.3%	4.2%	5.5%
U.S. – Amsterdam	94.4%	3.0%	2.6%
U.S. – Frankfurt	81.8%	12.1%	6.1%

Note: Virgin Atlantic included in Sky JV
* Based on monthly flights
Source: Diio MI July 2013 Schedule Data

What makes an alliance successful?

- **Factors that affect success of an alliance:**
  - Aligned expectations
  - Win-win financial provisions
  - Cultural compatibility (corporate and national)
  - Consistent quality and other customer relations
  - Network fit
  - Well-coordinated IT systems
    - E.g. WestJet-Southwest failure
  - Smooth airport interfaces
  - Coordinated selling and distribution

Discussion: Lufthansa and Turkish Airlines Relation

InterVISTAS

- **In 2006, LF sponsored TK's application to join Star Alliance**
- **Since 2010, TK and LF had been seeking closer co-operation**
- **In 2013, LF decided to end its codeshare agreement with TK**
- **Reasons:**
  - Strong growth of TK in Germany in particular secondary German cities (TK has more than three times LF's weekly frequencies between Germany and Turkey)
  - LF cannot match the fares with TK



THANK YOU!!!