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Mergers and acquisitions in the EU low cost carrier market. A Product and Organisation Architecture (POA) approach to identify potential merger partners

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A B S T R A C T

As the EU low cost airline sector matures, consolidation is expected. This paper details a three-stage methodology to examine LCCs mergers and acquisition activity. A series of depth interviews with aviation experts concludes that the motives for LCCs to enter mergers and acquisitions are largely similar to those of full service carriers. A key success factor for merging partners is to have similar business models and culture. An analysis of full service and low cost carrier mergers and acquisition activity events shows that the size ratio and degree of network overlap between merging airlines are also independent of airline type. Braxton and BCG analyses of EU LCCs show Ryanair and easyJet to be the only LCCs in the market with strong strategic positions across the markets they serve. Finally, an application of the Product and Organisation Architecture analytical approach was used to compare seven EU LCCs. easyJet and Vueling were found to have the most similar business models and were therefore considered the best strategic fit for a potential merger.

1. Introduction

Since the 1980s, two important aviation trends have dominated air transport research: airline market consolidation and the growth of low-cost carriers. However, very little research has considered the merger and acquisition activity of low cost airlines. This paper sets out to address merger and acquisition activity within the LCC sector with a focus on the EU market.

The liberalisation of the intra-EU air services market provided the legislative framework in which low cost carriers (LCCs) could develop. The 'Third Package' of aviation measures came into force in January 1993, with full cabotage following in 1997. This market liberalisation allowed airlines to operate between any points in the European Union (EU). These new regulations have had a similar effect to the deregulation of the US domestic market some twenty years earlier. US deregulation saw the establishment and growth of Southwest Airlines, the archetypal low cost carrier.

Ryanair was the first EU airline to take advantage of the new European regulatory environment. The company based its strategy on the successful Southwest model, which quickly proved to work perfectly well in Europe. Soon after, start-ups like easyJet and Debonair also launched low-cost services. Many legacy carriers reacted to the threat of low-fare airlines by establishing their own LCC subsidiaries (including BA's Go and KLM's Buzz), yet, most did not succeed (Francis et al., 2006). After a few years, the market went through an initial wave of consolidation. Market leaders Ryanair and easyJet both acquired smaller competitors, Buzz and Go respectively, whilst many other small carriers collapsed (Danklefsen, 2007). By 2011, one hundred and ten low cost carriers had entered the EU market but only thirty-two survived (Mason et al., 2013). The rest had either gone out of business, been acquired or had merged with a competitor.

Mergers and acquisitions (M&A) are means of rapidly achieving external corporate expansion and growth (Gaughan, 2011; Tickle, 1987). As companies merge, their resources are conjoined to increase the value in the combined business. The sources of added value are synergies found either on the revenue or cost side of the business. Revenue enhancements can be achieved in a merged company through the growth in scale of the business (Dobson and Piga, 2009), increased market power, increased product attractiveness, or access to scarce resources. Sources for cost synergies include removal of overlapping areas, efficiency gains (economies of scale, scope, density and learning), and tax benefits (Maruna, 2008; Merkert and Morrell, 2012).

Historically, global M&A activity has tended to follow patterns of "waves", with periods of increased M&A activity, followed by

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periods of relative steadiness or declines (Sudarsanam, 2003). Wang (2012) found airline merger activity tended to be cyclical and one significantly large merger may trigger a number of others in a region. The consensus view of a number of airline experts was that only two or three large low cost carriers will dominate the European market by 2015 (Mason and Alamdari, 2007). The consolidation trend towards a limited number of big LCC was also highlighted by Danklefsen (2007) in a study for the European Parliament and by Graham and Shaw (2008).

Whilst mergers offer opportunities to raise revenue and reduce costs, such opportunities are not automatically realised. Post-merger integration is the most crucial phase in the airlines' merger, considering strategic fit, revenue and cost synergies and cultural fit as the more important parameters for a successful merger (Maruna, 2008). Hanson et al. (2002) highlighted a number of reasons for failure of airline mergers including poor planning and execution, complexities caused by the labour component of the merger, and lack of familiarization with the business model of acquired company.

Over the past three decades analysis of airline consolidation as a function of deregulation and liberalisation, and the expansion of LCC sector, have developed parallel to one another. However, as the LCC sector is maturing, consolidation among this group of airlines is expected. There is lack of the systematic research on mergers of low cost carriers. Here we consider whether LCC mergers differ in any substantive way from the merger of full service carriers and to look at the likelihood of merger activity in the EU market and which carriers are most likely to be involved in such activity.

2. Methodology

To investigate mergers and acquisition impacts a multi-stage methodology is employed.

A panel of ten aviation experts were interviewed between May and July 2012 to gather opinions from a variety of aviation professionals with experience in LCC mergers. These included three managing directors of aviation consultancies, three directors of LCCs, and four senior managers at LCCs. There was a focus to interview respondents who were involved in one of the following mergers: Ryanair/Buzz, easyJet/Go or Vueling/Clickair. Despite several attempts, contact with Ryanair could not be established. Respondents were asked a series of open-ended questions regarding the reasons for an airline to merge with or acquire another airline, the key characteristics of a target partner and issues that may impact the success of a merger. The responses were unprompted. Following the interviews the responses to each question were categorised and frequencies calculated to identify the key responses to each question. The responses gaining three or more un-prompted responses were considered to be important.

To identify the general patterns of low-cost carriers M&As, recent airline mergers were analysed. Thirty-nine airline mergers (including both full service and LCC) were identified and investigated with respect of the relative size of the airlines merged, and the extent of network overlap. An airline's network structure is an essential feature for distinguishing low-cost airlines from traditional carriers. Dobruszkes (2006) provided a detailed analysis of the network structures of European LCC and provides an important framework analysing an airline's size and network. The M&A incidents investigated occurred between the Southwest's acquisition of Morris Air in 1993 and concluding with Southwest's merger with AirTran in 2011. A full list of mergers/acquisitions is listed in Appendix.

Data for the analysis of the size and network was drawn from the Official Airline Guide database (FlightGlobal, 2012), which provides a detailed and disaggregated description of the airlines' supply of capacity. For each merger data were collected on: the acquirer: operations (aircraft movements), seats and ASKs, the target airline: operations, seats and ASKs, and network overlap: airports served, routes and seats on overlapping routes.

For analyses, each metric was examined but an aggregated single measure, which would take into account both the differences in aircraft size and the stage length is preferred. As a consequence, an airline size parameter is developed for each airline engaged in a merger:

$$\text{Aggregated Airline Size} = \sum \text{OPS}/10^3 + \text{Seats}/10^6 + \text{ASK}/10^9$$

The powers applied to each item reflect the difference in magnitude of each metric. Subsequently, a size ratio for each merger was calculated, to assess the relative size of merger partners to each other. (The acquirer always refers to the larger airline, however in some cases, the merged entities used the name of the smaller partner.)

$$\text{Size ratio} = \frac{\text{Aggregated Target Size}}{\text{Aggregated Acquirer Size}}$$

Network Overlap was the final parameter to be assessed. There were various measures that could have been used to express this value. Overlap is assessed by looking at three items: airports, routes and network seats.

Airport Overlap is the number of airports operated by both airlines divided by the number of airports served by both airlines. Routes Overlap indicates the number of routes (O-D) were carriers compete, in relation to number of routes being operated. Finally, the Seats Overlap seeks to explain how many seats are being operated on the overlapping routes. Each parameter implies important operational consequences for the merging airlines. For example, the high Airport Overlap, means that facilities and services might be shared. The Routes Overlap illustrates how the network may expand after a merger, while the Seats Overlap describes how direct competition between two airlines might change. Finally Network Overlap was calculated as the mean of the three previous components. The following equations provide the methodology of Network Overlap calculations:

$$\text{Airport Overlap} = \frac{\text{Airports served by both carriers}}{\text{Airports served by at least one carriers}}$$

$$\text{Routes Overlap} = \frac{\text{Routes served by both carriers}}{\text{Routes served by at least one carriers}}$$

$$\text{Seats Overlap} = \frac{\text{Seats served on overllaping routes}}{\text{All seats served by both carriers}}$$

$$\text{Network Overlap} = \frac{\text{Airports Overlap}+\text{Routes Overlap}+\text{Seats Overlap}}{3}$$

Following the analysis of the relative size and degree of network overlap, an analysis of the strategic need for an airline to merge was examined. Merger activity may be expected when a market reaches maturity and therefore provides limited potential for organic growth. At this stage, mergers provide an opportunity to achieve the size, economies of scale and market power needed to compete with equally strong competitors (Tickle, 1987).

To examine the market situation with respect to market development both Braxton and Boston Consulting Group analyses were conducted. Both approaches place emphasis on the competitive dynamics of the industry. For each analysis the market growth rate and relative market share were examined. Growth was assessed by examining the annualised average increase in available seats from