european school
of management
and technology

ESMT No. BB-108-007

ESMT
BUSINESS
BRIEF

Consolidation Index for the European Airline Industry

Marten Büttner, ESMT
Christoph Burger, ESMT

ISSN 1866–4024

Citation:

Marten Büttner and Christoph Burger; **Consolidation Index for the European Airline Industry;** Business Brief No. BB-108-007; ESMT European School of Management and Technology, 2008.

Contents

1. Concept of the Industry Consolidation Index

As markets internationalize while consolidating, companies have to ask themselves if they can become leaders in these broader international markets. The consolidation index, developed by Burger[1], is a framework for developing and validating strategies in this regard.

The basic strategies of markets that internationalize while consolidating are either to become generalists with major market share to drive economies of scale, or to act as niche players. This is shown by the research of Porter, Sheth/Sisodia, and Deans/Kroeger/Zeisel[2], which indicates that companies earn the highest returns when following those strategies.

The consolidation index shows which competences have to be met in order to become a leading player:

- *Competitive competence*
  A company indicates a high competitive competence when it copes with the rules of the marketplace better than any other competitor. Key performance indicators are, for example, productivity per employee and market capitalization.
- *Financial competence*
  High competitive competence is not sufficient, though, to shape a process of industry consolidation. In addition, financial competence is needed to raise

[1] Burger, C. (2008). Consolidation Index: Critical Success Factors for Industry Consolidation. ESMT Business Brief No. BB-108-001.

[2] M. Porter, *Competitive Strategy* (1980); J. Sheth and R. Sisodia, *The Rule of Three* (2002); G. K. Deans, F. Kröger and S. Zeisel, *Merger Endgames* (2002).

funds, for example for takeovers. Some key performance indicators are: earnings before interest and tax (EBIT), equity, return on equity (RoE), gearing and the structure of investors (in order to raise additional funds).

- *Internationalization competence*
  As consolidation today refers either to a multinational trade region (EU, NAFTA, APEC, etc.) or a globally driven environment, a company has to assess its preconditions for a successful internationalization process. Key performance indicators are, for example, the existing foreign business and the management board's international expertise.

- *Change competence*
  Consolidation often requires significant reorganization of a company (due to new business models, rapid internal growth, and/or mergers and acquisitions). It is therefore vital to identify reorganization needs in time and to successfully drive the reorganization process. Key performance indicators are, for example, the scale and number of successfully completed reorganizations.

Given these requirements, the consolidation index shall serve as a management tool for managers in the aviation industry as well as an information tool for people with interest in the aviation industry:

- to identify a company's position in a consolidating environment and
- to assess a company's strategy in light of a larger consolidation process.

So far the consolidation index has been applied to the European banking[3] and utility industries.[4] Following recent deregulation, both industries are now in the rather early stages of the consolidation process. This business brief applies the consolidation index to the European airline industry.

[3] Burger, C. and Hagen, J. (2007). *Strukturumbruch in der Finanzdienstleistungsindustrie*.

[4] Burger, C. and Holtermann, M. (2007). *Europäische Konsolidierung in der Energiebranche – Beginn einer zweiten Konsolidierungswelle*? ESMT Business Brief No. BB–107–001/ger.

2. Application to the European Airline Industry

2.1 Applied Criteria for Consolidation Index

Next to the strong national component of the traditional airline industry, there is heavy internationalization taking place on the multinational as well as on the global level. Alliances such as Star Alliance, Oneworld, and SkyTeam have been formed in order to better serve the international market. Also consolidation is taking place. One can see an example of consolidation with the recently announced merger of Delta and Northwest, which makes them the largest airline in the world in terms of number of passengers.

Still, the European airline industry has a comparably low level of consolidation. The top five airlines in Europe have a combined market share of 31 percent, whereas the top five U.S. airlines have 67 percent. Other industries in Europe also show higher figures in this respect than the European airline industry. Examples include: the steel industry (61%), energy (72%), and automotive (66%)[5]. One reason for the low level of consolidation in the European airline industry is the emergence and successful establishment of low-cost carriers, meaning that a substantial number of new airlines have been formed with most of them still in operation.

[5] Boston Consulting database (2007).

Nevertheless, it is very likely that consolidation will increase in the European airline industry in the near future. Reasons for that are manyfold: there is evidence that mergers can be successful (e.g., Air France-KLM in 2004 or Lufthansa-Swiss in 2005); regulatory barriers will be lowered, as with Open Skies; the competition resulting from low-cost carriers offering long haul services will be tougher; and last but not least, further synergies from alliances will be harder to achieve.

This leads to the following questions:

- Which airlines have the potential to drive the consolidation process in the European market?
- Where do the European airlines stand on a global level regarding market share?
- Which is the right strategy for European airlines to pursue in the future?

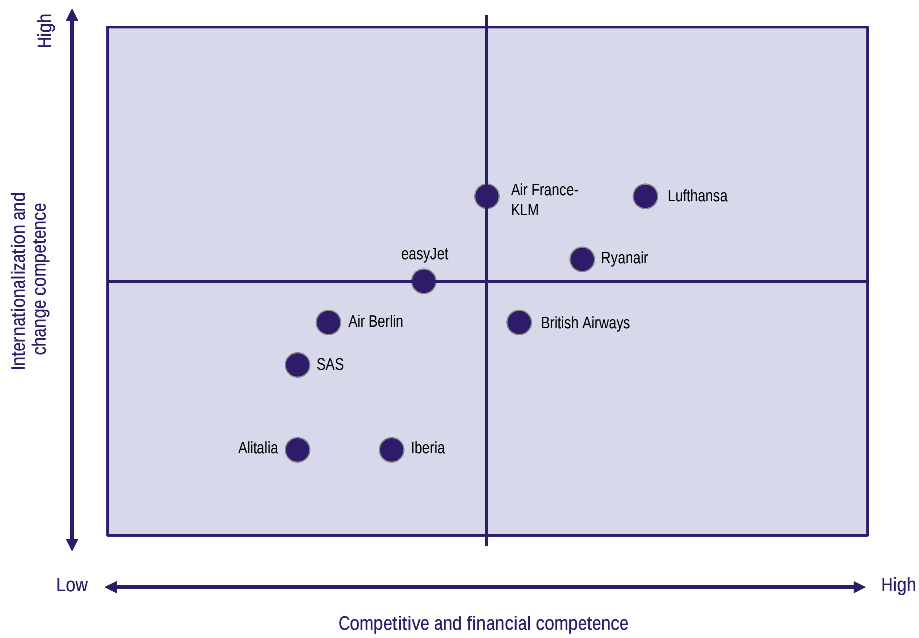
Under consideration are nine major European airlines, including the traditional incumbents as well as selected new carriers. The incumbents often follow a general strategy and offer their customers a comprehensive product and service range on a national or multinational level. In contrast, the new players follow a niche strategy with a clear focus on selected products/services and routes (point-to-point).

The consolidation competences have been specified as follows:

- *Competitive competence*
  revenues per employee and market capitalization based on annual reports and stock indices
- *Financial competence*
  earnings before interest and tax (EBIT) and return on equity (RoE before tax) based on annual reports
- *Internationalization competence*
  share of "non-home market" revenues and "non-domestic board" representation based on expert judgments
- *Change competence*
  scale and number of reorganizations and integrations within the last five years based on expert judgments

Exhibit 1 is derived from a rating scheme from 1 (low) to 5 (high) for all four consolidation competences. The results have been plotted in a matrix of competitive/financial competence and internationalization/change competence. Competitive/financial competence stands for the competitive strength i.e. the ability to take part in the consolidation process and internationalization/change competence stands for the competitive attitude to be able to drive the international consolidation process.

Exhibit 1: Consolidation Index for European Airlines (Analytical Calculation)



Sources: Annual reports 2007/2008, FAZ stock index, ESMT analysis.

2.2 Consolidation Index for European Airlines

Analyzing the results of the consolidation index for the investigated European airlines (see exhibit 1), the following conclusions can be drawn:

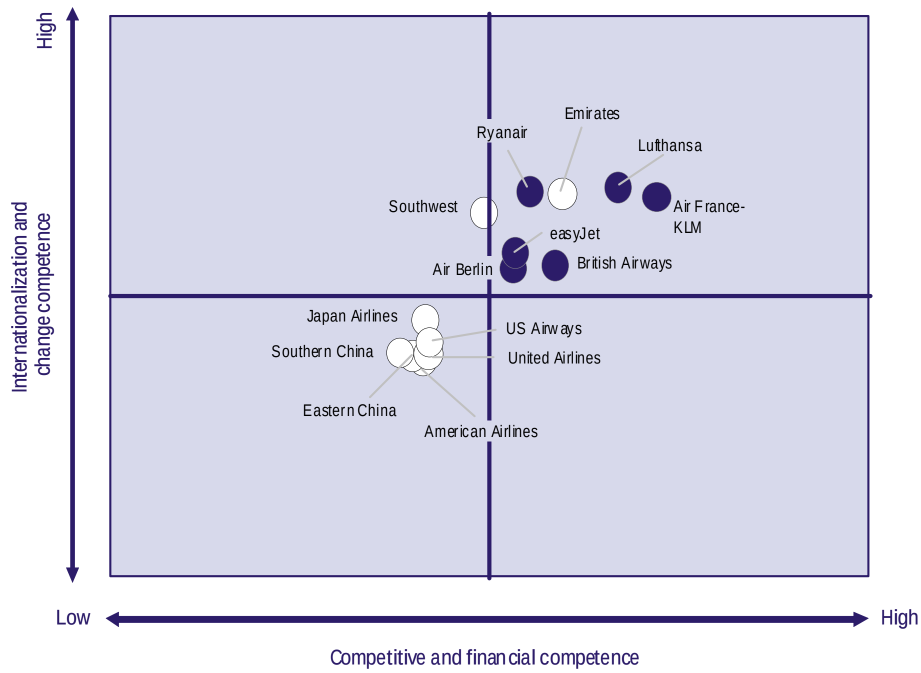
- Lufthansa, Air France-KLM, and Ryanair have the best starting positions to further drive the consolidation process in Europe.
- British Airways and easyJet are potential followers in this process.
- The remainder will not play an active role in further consolidating the European airline industry.

The European airlines do have some experience in consolidation already but they are pursuing different strategies:

- Air France-KLM has been the most prominent merger in the European airline industry and, in terms of revenues (and due to the strong euro), forms the biggest airline in the world.
- Lufthansa, as the other major European player on a global level, is carefully considering mergers. With Swiss they experienced a successful takeover and they also recently invested in the U.S. airline JetBlue in order to strengthen their presence on the U.S. market, especially at JFK airport. The takeover of 45 percent of Brussels Airlines has been announced recently and additional acquisitions are under investigation.
- British Airways is favoring the model of partnering as opposed to a complete takeover, as already seen with their 13 percent investment in Iberia.
- Iberia is looking for potential takeovers and would like to go for the local competitor Spanair, which currently belongs to the SAS Group, to build a more dominant position in its home market.
- SAS wants to concentrate on the Scandinavian market and is therefore interested in selling its stakes in BMI and Spanair.
- Italy´s contribution to the consolidation movement in Europe would be to sell Alitalia to an airline, but outside interest is limited.
- The low-cost carriers such as Ryanair, easyJet, and Air Berlin are acting as niche players, with a clear point-to-point strategy, and pursuing selective consolidation in their market segments.

In addition to the analytical calculation of the consolidation index for the nine investigated European airlines, ESMT has asked 20 European senior managers of the industry about their views on the four consolidation competences and to give qualitative evaluations of the positions of selected international airlines from Europe, the U.S., and Asia (see exhibit 2).

Exhibit 2: Consolidation Index for International Airlines (Qualitative Evaluation)



Source: ESMT Consolidation Impact Survey 2007.

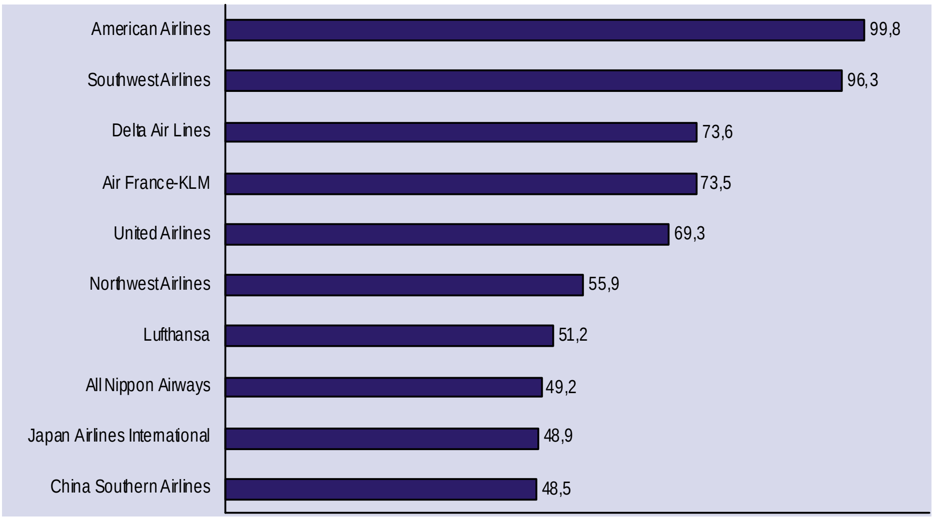
Based on this qualitative evaluation, one can see that the European airlines represented in both analyses (Air France-KLM, Air Berlin, British Airways, Lufthansa, easyJet, Ryanair) usually get higher grades in their consolidation competences in the qualitative evaluation than when they are based on the analytical calculations.

It is also worth mentioning that in the qualitative evaluation of the European airline managers, the European airlines tend to get higher grades than the U.S. and Asian airlines, with the exceptions of Emirates and Southwest.

2.3 Comparison with the Global Airline Industry

Among the top ten global airlines, only two come from Europe: Air France-KLM and Lufthansa (see exhibit 3).

Exhibit 3: The Biggest Airlines in the World (Million Passengers per Year)



Source: IATA.

The biggest airline, in terms of number of passengers, will result from the merger of Delta and Northwest. Additional U.S. airlines, as well as three Asian and the two mentioned European airlines, supplement the top ten list. Emirates, which is not on the list, has shown a strong intent to become one of the leading global players in the future. This is demonstrated by the more than 100 confirmed orders for aircraft, with which Emirates wants to increase its penetration into Europe as well.

The merger of Delta and Northwest will most likely result in a further consolidation of the global airline industry. United Airlines, Continental Airlines, American Airlines, and US Airways are each investigating possible mergers. That would make sense, especially for the domestic U.S. market where there are far too many hubs. A further consolidation would be a chance to better use the capacities in the U.S. market, avoid price wars, and cope with the high costs for fuel.

3.
Conclusion

Consolidation will drive the European as well as the global airline industry in the future. The recent merger of Delta and Northwest will foster the discussions about further consolidation and most likely lead to further takeovers.

This business brief about the European airline industry shows that Air France-KLM and Lufthansa are in a particularly good position to drive the consolidation process in Europe. On the other hand, these airlines could also be potential takeover targets in the global airline industry.

We expect that by the start of the next decade, some of today's airlines in Europe will have disappeared. The situation will get critical, not only for those purely national-oriented incumbents that are not operating profitably, but also for low-cost carriers, which face increased competition from strong incumbents and might suffer disproportionately from a potential economic downturn in Europe.

Generally speaking, late movers might find themselves as targets for takeovers. Strategic planning is required and there is a certain window of opportunity for corresponding actions. Not acting means that opportunities are gone – at least for some time.

The authors

Christoph Burger is the head of the practice group Telecommunication, Transport and Utilities at ESMT Customized Solutions, as well as a member of the faculty at ESMT.

Marten Büttner is a program director of the practice group Telecommunication, Transport and Utilities at ESMT Customized Solutions with a strong personal focus on the transport and logistics industry.

About ESMT

ESMT European School of Management and Technology was founded in October 2002 on the initiative of 25 leading German companies and institutions. The founders aimed to establish an international business school, based in Germany, with a distinct European focus. As a private institution of higher education, ESMT provides executive education (since 2003) and an international MBA program (since 2006). ESMT headquarters is located in Berlin with a further campus in Cologne. ESMT is fully accredited by German authorities as a private institution of higher education.

High impact learning

ESMT research and teaching focuses on practice relevance and applicability. High impact learning allows participants to translate what they have learned into action as soon as they get back to their companies and to bring about changes on the job. ESMT imparts participants with state-of-the-art analytical methods in management and teaches them to solve real-life management issues. The aim is to enable participants to take responsibility and accomplish change. ESMT faculty, made up of both practice-oriented academics and theory-oriented experts, supports this style of teaching.

More Information:

ESMT European School of Management and Technology
Schlossplatz 1, 10178 Berlin, Germany
Phone: +49 (0) 30 212 31-0
Fax: +49 (0) 30 212 31-9
www.esmt.org

ESMT
European School of Management
and Technology GmbH

ESMT Campus
Schlossplatz 1
10178 Berlin
+49 (0) 30 212 31-0
+49 (0) 30 212 31-1279 (Publications)

www.esmt.org