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by Lauren Etter and Nick Timiraos
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Is Airline Consolidation About to Get Under Way?

THE MAIN EVENT

Merger talks between United Airlines and Continental Airlines last week fueled speculation that airline-industry consolidation may be on the horizon.

POINTS OF VIEW

"We think [consolidation] is good and overdue for the industry, despite the fact that we acknowledge its difficulties."

-- Glenn Tilton, chairman and chief executive of UAL Corp.

"United is so desperate to merge I'm surprised they're not listing on eBay."

-- Michael Boyd, aviation consultant at Boyd Group Inc.

"Are fares going to go up? Yes. Do they need to go up for companies to continue to provide and improve their service? Yes."

-- Jay Sorensen, president of consulting firm IdeaWorks

"There have been more bad mergers than good ones."

-- Gordon Bethune, former chairman and CEO of Continental Airlines Inc.

"Merging firms is bad for the public. It disrupts their travel, it reduces their choice and it raises their prices."

-- Michael E. Levine, professor, New York University School of Law

A deal between United parent UAL Corp. and Continental Airlines Inc., while not imminent, would create one of the world's largest airlines by traffic. This is the latest action in an increasingly restless airline industry, which in recent years has been battered by soaring oil prices, bankruptcies and mounting competition from low-cost carriers.

Last month, US Airways Group Inc. made an \$8.44 billion hostile takeover bid for Delta Air Lines. If it succeeds, the combination would be slightly larger than United-

Continental as measured by traffic. Delta's board is expected to reject the offer next week and release its own restructuring plan.

The airline industry has just begun to recover from a sharp downturn after the Sept. 11 terrorist attacks. The industry has slashed nearly 28% of its work force in the past four years and is expected to turn a modest profit this year and a more robust profit in 2007.

Here's a closer look:

Why haven't airlines been making money? U.S. airlines haven't turned a year-over-year profit since 2000. Passenger travel fell 30% between August 2001 and October 2001, leaving the airlines with too much capacity. Rising fuel costs then caused carriers to spend more on fuel -- \$32 billion on 19 billion gallons of fuel last year, up from \$16 billion on 20 billion gallons in 2000. Moreover, airlines tend to be burdened with high debt payments.

Still, the future looks brighter, thanks to cost cuts and fuel prices that have come down a bit recently. Operating revenues rose 12% last year, and planes today are flying with about 80% of their seats filled -- the highest since World War II, according to the Air Transport Association.

So why consolidate? Profit margins next year are expected to be much lower than those of companies in other industries, according to Jim Corridore, an equity analyst at Standards & Poor's.

Consolidation could help airlines reduce capacity and fill more seats at higher prices, thus lifting profits. Mergers also could enable airlines to further reduce costs in areas like accounting and reservation systems. Another upside: Any mergers today likely would be structured with an eye toward recapitalizing debt and freeing up funds for new aircraft orders, which are in short supply today.

Hedge funds and private-equity investors, who are sitting on piles of money, welcome the idea of mergers. Last week, UAL shares were up nearly 5% following news that a merger may be a possibility. Since America West merged with US Airways last year, the stock of the new company has nearly tripled. Still, there are risks. Many airline mergers in the past have had poor results because of the complicated logistics involved, such as integrating fleets and labor-union seniority lists.

Will travelers suffer? Possibly. Mergers could reduce competition, limit choices and raise fares. For example, if Delta and US Airways merge, Montgomery, Ala., would have more than 70% of its flights served by the new airline, according to Michael Boyd, an aviation consultant at Boyd Group Inc. That could leave fliers with fewer seats to compete for and fewer routes to choose from. Still, price increases could be moderated by low-cost carriers.

Could antitrust concerns block the mergers? Maybe. Regulators' concerns about United's 2000 bid for US Airways contributed to United's cold feet and it ended up walking away from the deal. Continental and United sharing routes between their Newark and San Francisco hubs, and their Chicago and Cleveland hubs might attract attention from regulators. Antitrust skepticism of a US Airways-Delta combination might be even stronger, based on their large presence in the Southeast. US Airways already has said it would have to sell one of the shuttles the two operate between New York, Boston and Washington D.C.

FACTS

Compared with global peers, U.S. carriers are poor financial performers. Last year, U.S. airlines posted a \$6.7 billion loss, according to the International Air Transport Association. Asia-Pacific carriers posted a \$2.1 billion profit and European carriers had a \$1.6 billion profit.

Atlanta has the busiest airport in the U.S., putting 27.5 million passengers on planes in the first eight months of 2006. Chicago O'Hare is the next busiest, followed by Dallas-Fort Worth and Los Angeles International.

Domestic airfares have increased 45% since 1978 before being adjusted for inflation, according to the Air Transport Association. The price of milk has increased 133% and single-family homes have risen 326%.

Fuel came to 26% of total operating expenses for U.S. airlines in the second quarter of 2006 -- the single largest expense, the Air Transport Association says. Labor came in second at 24%.

Last year 734 million passengers flew on U.S. carriers, up 5% from the year before. American Airlines carried 67 million passengers from January to August, more than any other U.S. carrier. Southwest came in second with 65 million.

Airlines go to great lengths to build customer loyalty. JetBlue Airways touted leather seats and satellite TV on all its flights when it started flying in 2000. Midwest Airlines serves chocolate chip cookies baked in-flight.