



Is Consolidation the Only Option for All Airlines?

The Case for Indigenous Control of Aer Lingus

Paul Sweeney

April 2015

Abstract

IAG group, a UK multinational, is making a bid to take-over Aer Lingus by purchasing shares currently held by the Irish Government. In this think-piece, Paul Sweeney argues that instead of selling shares, Ireland should invest more in Aer Lingus, by increasing its shareholding in Aer Lingus from 25.1% to 50.1%.

He argues that the current push to sell Aer Lingus shares is a result of lobbying by IAG and those who would benefit from the sale, and is not motivated by what is in Ireland or Aer Lingus' best interest.

The paper argues that Aer Lingus has many strengths and that consolidation into a major airline group is not necessary to ensure its survival. The paper also challenges the notion that privatization is always good and state ownership always bad. Government investment in Aer Lingus, the paper concludes, would be a bold and ambitious move.

Paul Sweeney is Chair of TASC's Economists' Network. From 1990 to 2005 he was Financial Advisor the Trade Union group within Aer Lingus. The views in this paper are the author's own and not necessarily those of TASC.

Introduction

There is a strong, post-colonial inferiority vibe coming from the advocates of the sell-off of Aer Lingus to the big, superior and well-endowed British Airways' owner IAG. These are some of their comments:

- "Sure it's a big boys game now and we can't compete."
- "What will Aer Lingus do if it needs more money to buy new planes?"
- "If there is a cyclical downturn, the airline could go bust, it's the best offer we will get"
- "What happens if the bid fails and the share price falls"?

The key issue missing from the debate, particularly in the financial pages, is the lack of a strategic approach. The only hint of this is from Paschal Donohoe, happily the Minister in charge of Aer Lingus. The worry is that he is only being cautious rather than strategic. He has the added task of winning over his cabinet colleagues.

Strategy is seen simply in the short-term protection of the Heathrow slots. It is much more than that. It is about industrial or enterprise policy over the long term; about the role of indigenous firms; and about the large subsidies and supports which the government and its many agencies give to enterprise here.

Enterprise policy is not just about what makes commercial sense for one company. And what makes commercial sense in the short-term may not be long-term strategy. And national commercial sense differs from orthodox commercial sense.

Background

IAG group, a UK multinational, which owns British Airways, Iberia, and Vueling Airlines, is making a bid to take-over Aer Lingus. Aer Lingus was privatised in 2006 and the state still holds 25.1% of the shares and with another 5% it can control the slots in Heathrow. Aer Lingus is quoted on the stock exchange, with Ryanair holding 29%, the state with a quarter and Emirates with a small shareholding.

Ryanair now has to divest down to just 5% as it is breach of UK competition rules. Ryanair is this fighting this, but is likely it will lose. This provides the Irish government with a unique opportunity to undo the harm done by the previous government in turning this important commercial and infrastructural asset into a political and commercial football.

Aer Lingus was set up by the state in 1936 and has developed into one of the best performing legacy (old established and in its case state owned) airlines in Europe and has a super brand name, key routes, great staff and provides reliable services in Europe with superior service to the low cost airlines and is a profitable European player on Transatlantic routes.

There has been consolidation by merger and takeover of many airlines in the US and Europe. Some see consolidation as inevitable and argue that there is therefore no room for smaller airlines in Europe. Aviation is a cyclical industry and only big airlines can survive the downturns and possible other challenges, the sellers argue.

There has been consolidation in both the US and Europe with the emergence of a few mega airlines, but there are also many smaller and medium sized airlines too. Scale does give benefits in aircraft purchase, but it will be seen that it is not the only strength. There are around 80 airlines in Europe and Aer Lingus is 17th largest by one criterion, passenger numbers.

The debate has been reduced from strategic national options on enterprise policy, the offer price, the value of the brand etc. largely to the value of Aer Lingus' important Heathrow slots. IAG has offered not to sell them for five years and the sell-off advocates are saying if the government gets longer, it should sell.

Selling shares would be a dis-investment for a once-off payment of €320m. This is at a time when investment in the Irish economy is historically low. For Aer Lingus, this will result in them becoming a small cog in a big shareholder (i.e. short-term profits) dominated multinational based in London.

A better alternative would be for the Government through New Era, the State Holding Company, to take 50.1% of Aer Lingus by buying up Ryanair's and other's shares. This would retain Aer Lingus as an Irish controlled airline, serving this island. It would be very productive investment by the state.

Retention would be very popular with the Irish people. It would not be with those who believe the market always provides. It would also finally take the company out of the uncertainty of the game of takeovers and mergers. It would ensure Ireland had a dependable Irish airline which can grow and provide good links with the rest of the world.

Bold and Ambitious

The right decision is not just to hold on to the 25% of Aer Lingus remaining with the state, but to be bold and ambitious for Ireland. Few governments have been bold and ambitious for Ireland. Minister Donohoe has to persuade this overly-cautious Cabinet government to get New Era, the state holding (privatisation) agency, to take control of Aer Lingus.

It is interesting to see how many in the media have succumbed to the intense lobbying from IAG and their stockbroker and other professional advisors who will gain from the sale. For example, it is estimated that former Aer Lingus chief executive, Christoph Mueller, could gain close to €4.4 million from his share-holding¹.

Here is the kernel of the lack of strategic thinking from Government:

“A significant number of ministers contacted by The Irish Times said selling to IAG would make commercial sense and could be in the best long- term interests of the airline”
(Irish Times, 3rd April 2015)

The role of government is what is in Ireland’s interest - not what is in “the commercial interest” of a company.

Is Scale Necessary for Survival in Aviation?

Some argue that only big airlines will survive. But airline mergers have yet to prove a financial success. Iberia’s losses in 2012 put a big hole in BA’s profits. A further issue is that cost savings from rationalisation of cross-border workforces are hampered by political sensitivity. It is a key job of governments to ensure that there is no repeat of the mistake of again letting markets provide all solutions.

The largest Airline group in Europe is Lufthansa which made a loss of €732m last year in spite of cutting costs by €2.5bn in recent years. These cost reductions were offset by lower fares and rising costs elsewhere. It has net debts of €3.4bn whereas little Aer Lingus has net cash of over €600m. Lufthansa also owns no-frills Germanwings and Eurowings and also cargo, maintenance and catering units. With its losses it did not give dividends for the second time in three years. So it is not size but adaptability which is important to survival. As a small part of IAG, Aer Lingus, even as a separate unit, will be far less flexible and will not be able to innovate as much.

Lufthansa is Europe’s largest airline by number of passengers, followed by Ryanairⁱⁱ. Aer Lingus is in 17th position. This is only one measure of size. For example, airlines which have the more profitable long haul routes would have far fewer passengers. Aer Lingus has a very good mix of both long and short haul and comparing only short-haul airlines with long-haul ones on only passenger numbers is like comparing apples and oranges.

Lufthansa, Aer France and IAG have extensive long-haul, as their large fleet (or larger aircraft) may indicate. Their passenger numbers did not grow organically but by merger. Ryanair is not in the top 10 world airlines by passengers per kilometre flown.

Interesting, Pegasus at 12th was initially set up by Aer Lingus as a subsidiary. Most interesting of all is the rapid growth of Norwegian Air, up from just 3 million to 24 million passengers in the decade. This could be Aer Lingus with a more supportive shareholder in the future, if the government acts now and take back a majority through New Era. Aeroflot and Turkish have grown rapidly too in this period.

Yet there have never been so many airlines, in spite of the mergers and takeovers. In Europe there are 51 airlines of some scale as per the list of top airlinesⁱⁱⁱ. In the world there are over 5,000 airlines, according to estimates. There is consolidation but simultaneously growth in the number of airlines. Does Aer Lingus have to be taken over? Is there protection in size?

The phone App is Flightradar24 allows you to point your phone at an overhead aircraft and it tells you it is an Aer Lingus 320 flying from Heathrow to Dublin at 1,902 metres, at 340 miles an hour, 50 minutes in the air, landing in 10 minutes in Dublin. You can get a simulated view from the cockpit as it comes in to land, showing Howth, Dun Laoghaire harbour to the south or Portmarnock to the north, with the squawk and the model of aircraft and a picture of the type of plane.

It tells you there are 7,266 aircraft in the air worldwide on this weekday mid-morning (excluding some military and small aircraft). You can move to any place on the globe and see what aircraft are flying there. (Most military and small aircraft are not tracked). You can see how many airlines there are with planes in the air all over the world. I tried to count them but failed as there are so many airlines. There are so many beginning with A that Aer Lingus is 11th on this long list.

The key argument for consolidation - for oligopolies - is that large airlines can buy aircraft cheaper by getting bigger discounts than little ones. Aircraft is one of the biggest costs of airlines. This appears to be correct. There are discounts for big orders.

Yet timing on purchases is more important. If an airline buys in a downturn it will also get a big discount, even if the order is small. When all other airlines are heavily investing in new aircraft it may lead to overcapacity and this often ends with losses form many.

Leasing

A growing alternative to tying up capital in buying aircraft is to lease. It may be dearer than owning, and the capital up-front cost is low and the price is based on length and type of the lease. If cleverly executed, leasing can save a great deal of money. There are also major tax implications with the differing options.

Ireland is a world-hub for leasing and information is readily available on what is the best way to manage capital investment. It was a former Aer Lingus executive Tony Ryan which the company backed to make Ireland the aircraft leasing centre of the world.

Major Downturns

Another obstacle placed in the way of continued indigenous ownership of Aer Lingus is that in the event of a major downturn in this cyclical industry, the company will not survive. In spite of 9/11, Aer Lingus survived and indeed grew. Profits turned to losses after the 2006 privatisation, though this was due to exceptional circumstances^{iv}.

Aer Lingus is much better placed today with judicious investment in aircraft, and with other problems like the pension resolved it is on a firm footing to expand on its own. A supportive shareholder which wants this company to grow would be helpful.

It is also argued that the state shareholding would be put at arm-length in New Era which would act as a developmental agency, providing additional capital if the company sought it, if it met the necessary criteria.

Efficient use of Capital is More Important than Size

A key argument in favour of takeover is that the airline industry made more in losses than in profits for many years. Its management did not seem to grasp how cyclical the industry was and was unable to learn not to over-expand in frenzied drives for market share. Those companies that do not over-invest in the good times will survive.

The capital cost of aircraft is a major issue. Many aircraft spent too much time on the ground in the past. Southwest Airlines, the innovator of low cost, grasped this key point. It persuaded its (unionised) staff to ensure fast turnarounds and the rest is history. Its founder Herb Kellerman insisted that Southwest was unionised to counter management power.

The commercial airline business has been one where it was very difficult to make money. This is changing, driven by the low-cost airlines. In 2013, the return on equity went from minus 50 per cent at Air France-KLM to plus 35 per cent at Japan Airlines. Of the nearly 40 listed carriers with market caps of over \$1bn, less than half made double digit returns. It is very cyclical and when there is a boom, money flows in. Then the airline bosses immediately expand their fleets and staffing. This leads to gross overcapacity in the next year and this leads to losses or collapses. More prudence on the up-side is required.

Many US airlines have nearly collapsed in spite of their size and some several times. US Airways has been through Chapter 11 proceedings twice, and United and Delta once each. AMR owner of American Airlines avoided this until 2013 when it filed for Chapter 11, protection from its creditors.

The US has had mega-mergers, where Delta combined with Northwest, Southwest with AirTran and United with Continental. Today there are three legacy carriers plus Southwest. These four airlines have 80 percent of the US domestic market.

Legacy Airlines are Catching-up with Low Cost Airlines

Legacy airlines have lost much of their short-haul business (flights of less than three hours) to the low-cost carriers, but they continue to dominate the skies on the longest routes because the low cost model has not yet worked on these. Laker was the first to fail, and also Oasis Hong Kong Air lasted a year and then AirAsia failed too. However, Norwegian Air Shuttle, a low-cost carrier has expanded across Europe, has now started flying across the Atlantic and to Thailand. It could prove a challenge to the dominance of BA, Lufthansa Air France/KLM.

A study of airline unit costs by KPMG shows that “over the past six years, the difference between the cost base of low cost carriers (LCC’s) and legacy airlines has narrowed dramatically. “In many geographies, from a passenger viewpoint, the distinction between

the two business models (particularly in short-haul) is also becoming increasingly blurred,” it says.

Ryanair, with the advantage of its greenfield low costs and infamous parsimoniousness does not always chose well. This year, it will face very high costs on fuel. Fuel is a major cost for airlines. The company hedged its fuel costs at \$92 a barrel for next year, meaning it will not gain from falling oil prices which slumped below \$50 per barrel. It made a costly mistake. Aer Lingus has been more astute and so will do much better this year on fuel costs.

Aer Lingus is probably the most successful of the legacy airlines in adapting to the new era. It and many other legacy airlines have reduced costs and fares substantially and are making more money by charging passengers for everything. Aer Lingus charges for meals on long-haul. People are wooed by the basic fare, some without even without looking at so called “taxes” and the many other hidden charges.

Thus Aer Lingus is one firm that has proven already that it is an adept regional independent player in a world with some big airlines. It has 50 planes, 10 million passengers in 2014 and a turnover of €1.6bn.

Cost Reductions and Cost-Shifting

The aviation industry paid its workers well and they had good benefits too, exceptionally so in some cases. This is changing and many costs are being shifted from airlines to workers... and passengers. This, however, can only go so far.

For example, Ryanair does not employ most of its workers directly and saves a fortune in pensions and other payments (imposing the costs on workers), and those it does employ are employed in Ireland because of its “business friendly” environment of a) the lowest employer social charges in Europe, b) the tax lowest on corporate profits and c) no right to collective bargaining through independent trade unions.

However, there are moves in Europe to end this exploitation of workers through contracts and collective bargaining for unions will finally be legalised again this year in Ireland. This will restore more balance in competition between airlines.

Ryanair made over €1 billion in 2013 from ancillary charges i.e. for bags and excess luggage. Its ancillary services have grown from 13.9% of total operating revenues to 20% plus. Interestingly, it is also treating passengers better and it has an immense investment programme of aircraft purchases.

Strengths of Aer Lingus

Aer Lingus is one of the most profitable airlines on the transatlantic route. This would not have happened if it had been under the control of IAG.

Mike Rutter, Aer Lingus’ chief revenue officer, told a conference at end of March that the company’s success in capturing a growing share of the market for flights between Europe and North America and in attracting travellers from outside its traditional (Irish) market has

built this into a robust business. He also admitted that this was attracting the IAG bid. Whether they want to take this traffic back, or maintain it is unknown, but it would not have happened if the Aer Lingus had been run as a small subsidiary of IAG in London. He said half of Aer Lingus transatlantic business is from passengers transferring to its services from flights in Europe and the US. Will IAG allow British Airways and Iberia to continue to lose this traffic to Aer Lingus when it owns the Irish airline?

In spite of Ireland's small population, Dublin airport is now in the top 20 airports in Europe and is fifth on the transatlantic route. It was little independent Aer Lingus that built this up over the years. It is believed that Aer Lingus also has a very profitable business class on this route. BA would like that segment of the market too.

Aer Lingus has one of the most powerful brand names not just in Ireland, but internationally with the Irish diaspora. It also has some of the best Heathrow slots (discussed in early blogs).

Consolidation has its Limits

Consolidation was the mantra in the 1990s at aviation conferences and in journals. It was slow to start but since then there has been a great deal of consolidation in aviation, perhaps soon leading to near oligopolies. As in many businesses, there may be a few large companies, but there is plenty of room in the airline business for mid-sized and small airlines too which often can be more innovative and nimble.

The next phase in aviation may see authorities and states trying to break-up the big oligopolistic airlines and other dominant players (other than the aircraft manufacturers which need immense scale and which do compete across continents). Already we are seeing some evidence of this in the UK competition office's recent decision to order Ryanair to divest itself of most of its stake in Aer Lingus for reasons of competition and in Virgin's complaint on competition grounds against this takeover.

The consolidation of major airlines has been the natural result of liberalisation. The airline business was one of the most restrictive sectors. It had to be opened up if it were to survive in the modern world. Government departments set the fares and they only allowed them to rise (not fall!). You could only buy a return ticket. There was no competition except bilaterally i.e. between the airlines of one country and those airline(s) of the other. Aer Lingus competed with BA to Britain and with Aer France to and from France. Airlines were mainly – not all - state-owned in Europe. Even today the US still has a restrictive regime and does not allow foreign ownership of any airlines.

The US was the first to liberalise its skies and it has led to greater consolidation within its border, but its airline industry is still limited to US-owned airlines only. That is a big limit on US liberalisation. There is a balance to be struck between over-regulation and liberalisation but there is no balance between cost and safety. Safety must be paramount.

However, consolidation of the industry does not preclude regional airlines from thriving, provided they are profitable and of adequate size within their areas of operation. Indeed, I

would argue that today such is the level of consolidation at the very top of the airline business, that competition is being eroded.

A Few Airlines in Europe or Breakup of Oligopolies?

Is consolidation the next step? There are around 80 airlines in Europe. This is hardly an indication that there is no room for small airlines. Yet there is a high level of consolidation with the top six very large airlines carrying over 50 million passengers each a year.

Perhaps the big issue with consolidation is that the big airlines do not abuse their growing, dominant positions. This is a key part of EU rules and if the regulators are slow to act, the airlines can go to the ECJ. A great strength of American capitalism was the Anti-Trust laws which broke up the monopolies of the Robber Barons in the early 20th century. Today, the US authorities seem reticent to take on the monopolies, particularly in the technology sector, (GAFA – Google, Apple Amazon and Facebook). The EU competition directorate is also slow to act but better than it was in the past.

The next step in aviation may lead to the breakup of the emerging new airline cartels and oligopolies, but restraint of the abuse of dominance by the big airlines may now be an emerging issue.

It is being said that this year, 2015, in spite of fuel prices falling, fares out of Ireland, have risen considerably on last year. A brief check of a few routes shows a remarkable similarity in the high fares between so-called competing airlines.

While big airlines can dominate and abuse market dominance, it is possible that just two airlines say for the sake of argument, Ryanair and IAG, could set prices in regions in which they have a duopoly on routes (should Aer Lingus become a small subservient subsidiary of IAG).

State Shareholdings is a very viable form of ownership

The idea that “state ownership is bad and private is good” has been proven beyond doubt to be false with the recent spectacular collapse of the top Irish private firms (all Irish banks, including trouble for the four recently privatised state banks, most developers, Quinn Groups etc) and the healthy survival of those commercial firms remaining in state ownership (ESB, BGE, Coillte, DAA etc).

What ails the Irish financial media that so many there only see privatisation as the only way forward for enterprise? Why are they so limited in their vision?

If well run, at arm’s length, state ownership is another legitimate form of ownership, which can take a longer-term outlook and thus be more successful. While globally the number of state-owned firms has decreased overall, the number of truly important state-run companies, such as oil and telecom firms, has remained steady. Importantly the state retains substantial stakes in many private firms.

11 per cent of German economic activity is provided by commercial State-owned firms. In Ireland it was high until privatisation began in the 1980s. If they are operated at arm's length, as they have to be today, they perform well. Over time they operate just as well as private firms and as we have seen recently – far better in some cases. Aer Lingus was a commercial Irish firm that operated well (not perfectly at times) for over 70 years in state ownership. It can and should do so again. This sell-off would make it a very small part of a huge foreign multinational corporation, where shareholder value (short-run profit) will dominate all its operations, totally.

IAG wants to consolidate its command of Heathrow, partly to compete with the three Middle Eastern “super carriers” Qatar, Emirates and Etihad which have no capacity restraints on their home hubs. There has been consolidation of legacy European airlines around three major airline groups: IAG, Lufthansa and Air France-KLM and there are also Easyjet and Ryanair dominating in Europe, but with many other airlines too.

Sir Tim Clark, president of fast-growing Emirates Airline, was recently in Washington rebutting allegations by US carriers that state-controlled Emirates has benefited from billions of dollars' worth of state subsidies. With the A380 as its flagship aircraft, Emirates has increased market share bringing large numbers of passengers and cargo through its Dubai hub to 148 destinations around the world. Emirates has a supportive state shareholder, which is simultaneously investing \$7.8bn to expand Dubai International and also investing \$32bn investment in the Al Maktoum airport to the south of the capital city.

A vast number of major companies are owned by government throughout the world (for example: the 6th and 10th largest ten firms by market capitalisation in Q4, 2014). The 13 largest energy companies, by the reserves controlled, are now owned and operated by governments. Saudi Aramco, Gazprom (Russia), China National Petroleum Corp., National Iranian Oil Co., Petróleos de Venezuela, Petrobras (Brazil) and Petronas (Malaysia) are all larger than ExxonMobil, the largest of the multinationals. Altogether, multinational oil companies produce just 10% of the world's oil and gas reserves. State-owned companies now control more than 75% of all crude oil production.

Some of the most successful Irish firms were and still are state-owned. Ireland's economy used to be called a “mixed economy” that is of state and private sector.

The reason why there is such an ideological objection to direct state ownership of commercial enterprise in Ireland is baffling, particular with the recent collapse of some many of the top Irish private firms. When they failed, the state took control and saved them. They – particularly the banks and property companies - are to be sold off when restored to viability by the state and so the state/taxpayer is not to gain on the upside. This is a contradictory and an ideological strategy. The compulsion not to revert to state control (50.1%) of Aer Lingus, a strategic company for an island economy, which is commercial successful, is an example.

Conclusion

It was argued that small airlines can have a great future in aviation. Consolidation in the industry has also been accompanied by a growth in the number of airlines and it is the flexible airlines which survive and grow. Aer Lingus is both flexible and expanding. It has been very active in reducing its costs to near those of the greenfield low cost carriers while maintaining a superior service.

On its own, it has been very innovative and has hoovered up a great deal of transatlantic passengers from the UK and other countries, something it could not have done if it had been in the icy grip of IAG. It has learned to use its expensive capital – the aircraft - to the maximum. It has hedged its fuel better than much bigger Ryanair.

It has been argued that while size gives an airline bulk purchases discounts, timing in investment in expensive investment is more important. Good timing can provide better discounts. Another option is leasing, but it has to be undertaken cleverly. Ireland is the world capital of aircraft leasing.

Air New Zealand had to be renationalised in 2001. This won't be possible with Aer Lingus as it will be part of IAG group if the bid succeeds and it will not be quoted on the stock market. Thus to replicate the company, it would have to be built up from scratch, find staff, expertise, capital, aircraft etc. and simultaneously compete against Ryanair IAG and the other airlines and what is left of Aer Lingus.

Some of the fastest growing airlines are state-owned. The ideological hostility to state ownership is not just misplaced, but dated. EU rules have preclude favouritism and subsidies to state firms for decades and some of the best firms in Ireland are state owned. State ownership should not just be for rescue but for long-term growth too.

The best course is for the government to be bold and strategic and instruct New Era to buy up to 50.1% of the shares in Aer Lingus as Ryanair divests. Ireland would retain a major indigenous company and have its own strategic Air Bridge with the rest of the world, which can continue to expand.

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