Merger talk: Pie in the sky

Catherine Sutton-Brady
Faculty of Economics and Business
The University of Sydney
Economics and Business Building, (H69)
NSW 2006, Australia
Tel: 61290369306 Fax: 61293516732
e-mail: c.sutton-brady@econ.usyd.edu.au

Abstract
The outgoing Qantas CEO, Geoff Dixon, in his last TV interview in October 2008 said that the airline industry worldwide is too fragmented and there is a need for airlines to merge to maintain competitiveness. Just one month later British Airways announced in London that they were in merger talks with Qantas. This paper follows this story analysing newspaper reports by way of documentary analysis. The data gathering started prior to the announcement and ends just after it was announced that no merger would take place.

The paper investigates the concept of cooperation with competitors in an increasing competitive industry. Mergers within the industry have been commonplace in the aftermath of 9/11 and are an obvious extension of the many alliances that exist in this industry. Interfirm cooperation in the airline industry has been ongoing for many years with many airlines sharing resources and infrastructure, this paper looks at taking this cooperation much further in the form of a merger. The merger would involve combining the resources of the companies rather than just sharing them and combines the business into one business entity. This merger would have eliminated competition and considerably changed the network of business relationships in the industry.

The purpose of this study is to gain a better understanding of interfirm cooperation and competition in this network setting, something which few other authors have tried to do (Hagberg-Andersson and Tidstrom, 2008). It also investigates the rationale for merger discussions and explores why these firms thought it was necessary to go beyond the alliance they already had. It is argued that the choice between a merger and alliance revolves around choosing the form that best suits the firms need for control versus flexibility (Hoffmann and Schaper-Rinkel, 2002). Those firms with a high need for control, i.e. high transaction-specific investments and uncertainty regarding partner behaviour, should favour mergers. While when flexibility is needed because of changing technologies and dynamic competitive conditions, alliances are the preferred choice (Sawler, 2005). The study also looks at the potential synergies the parties envisaged in the merger and examines the pursuit of value through merger and the importance of relationships in the process (Madhok and Tallman, 1998).

The findings of this study make a valuable contribution to the literature on interfirm cooperation and competition, specifically incorporating mergers. It is also significant in providing a network view of mergers in this context. The managerial implications lie in the area of relationship management and strategic choice.

Keywords: Competition, Interfirm cooperation, Networks, Mergers

Merger talk: Pie in the sky

Introduction

In recent years the airline industry has been through much turbulence. In the aftermath of the terrorist attacks of 9/11 many airlines were forced to merge or went out of business. So it was not surprising to hear Geoff Dixon, the outgoing Qantas CEO, in, in his last TV interview in October 2008 say that the airline industry worldwide is too fragmented and there is a need for airlines to merge to maintain competitiveness. Airlines nowadays continue to face many challenges, throughout 2007 and 2008 fuel prices skyrocketed putting enormous pressure on many airlines. (IATA 2008). Luckily for many the booming economies cushioned many airlines from the impact of the fuel price rise however today the situation they face is not so optimistic. The global financial crisis is having a huge impact on airlines and the forecast for 2008/2009 is not good (IATA 2008). Already many airlines are cutting routes and laying off staff as the pressure mounts on profitability. Fuel prices are expected to remain high, many airlines are expecting new deliveries of aircrafts, these factors coupled with the economic downturn make it inevitable that many airlines will be unable to sustain profitability and many are expected to make huge losses. As a result of this in the past few months alone airlines worldwide have made 26,000 employees redundant.

This doom and gloom exists in a highly regulated industry, an industry where government regulations make it hard for companies to form alliances or merge.

> *"The flags on the tails of airlines are sinking the industry. Airlines need commercial freedoms to serve markets where they exist and to merge or consolidate where it makes commercial sense"* (Bisignani, 2008)

However some governments have begun to look at relaxing foreign ownership laws often seen as the biggest stumbling block for mergers. Airlines in Canada, Australia and India have been lobbying hard to bring about change. The need for change stems from the growing concern that exists about airline access to capital. The law changes in Australia and India specifically look at how much foreign airlines should be allowed to invest in local carriers, presently both countries limit foreign ownership to 49%, but India doesn't allow any in its airlines while Australia limits Qantas to 35%, with an individual maximum of 25% (Knibb, 2008).

The many challenges facing this highly competitive industry have lead to much discussion about the need for consolidation. This paper will address the issues of competition and cooperation in this context. Firstly I will briefly provide information relating to the two companies which are the focus of this study. This will be followed by a discussion of mergers and alliances in competitive industries and the ever changing shape of the network of relationships that exist. The method used to analyse the data gathered will be presented. A discussion of the findings will follow and the paper will conclude with the implications both theoretical and practical which arise in this context.

The Qantas Group

The Qantas Group is one of the world's oldest and most successful airlines. They currently employ 36,000 employees worldwide and serve 151 destinations in 38 countries. In terms of revenue passenger kilometres (RPKs) in 2008 Qantas was ranked no. 11 in the world with RPKs of 89,0090m based on a total of 32,065m passengers (ATW 2009).

The Qantas Group operates two airline brands Qantas its' flagship airline and Jetstar its' low cost airline. In addition it has a diverse portfolio of airline related business, including Engineering, Airports, Q Catering, Qantas Freight, Qantas Holidays and Qantas Defence Services (Qantas Annual Report 2008).

The complex network of relationships in this industry is evidenced by some of the other shareholding the Qantas group has. While Jetstar's Australian operation is wholly owned by Qantas, Jetstar's intra Asian operation is run by the Singapore-based Orangestar. The Qantas Group recently increased it's 49 per cent interest in Orangestar Investment Holdings Pte Limited, which also owns and operates Valuair, based in Singapore to 49% (www.asx.com.au). This change in shareholder structure allowed for Jetstar Asia and Valuair to be more closely aligned with Jetstar's Australian operations and provide a platform for the Jetstar brand to grow into more markets in the region in anticipation of more open skies across Asia. Additionally Qantas has an 18 per cent share in Vietnam's Pacific Airlines, which now operates as Jetstar Pacific and also holds a 46.3 per cent interest in Air Pacific (www.qantas.com.au). Qantas is also a member of the oneworld alliance and outside this alliance has 25 other code shares agreements (Qantas Annual Report 2008).

British Airways

British Airways (BA) is the UK's largest airline and the second largest airline in Europe behind Air France/KLM. They currently have just over 42,000 employees worldwide and fly to more than 300 destinations. In terms of revenue passenger kilometres (RPKs) in 2008 BA was ranked no. 9 in the world with RPKs of 101,648m based on a total of 29,774m passengers (ATW 2009).

BA also has a portfolio of airline related business, including Engineering, BA Holidays, BA maintenance and insurance. Like Qantas BA is a member of the oneworld alliance and has additional code share agreements with 4 other airlines. BA in the last year increased its share in Iberia from 9.95% to 13.15%. BA state, in their annual report, that they will look for further opportunities to increase their stake in Iberia, because of the strategic importance of this relationship (BA Annual Report 2007/2008).

BA highlight three key alliance that they have with other airlines. They have a Joint Service Agreement (JSA) with Qantas. The JSA is described as a strategic, tactical and operational cooperation between the parties. It applies to all flights that operate between UK/continental Europe and Southeast Asia/Australia. They share all costs and revenues on the JSA routes providing incentives for both companies to improve the joint business .BA has a major codeshare agreement with American Airlines(AA), they code share on 120 AA routes, while AA codeshare on over 80 BA routes. They do still compete on North Atlantic routes. The final key alliance is obviously with Iberia (the Spanish carrier), in addition to their 13.15% stake in the company they also have a Joint Business Agreement (JBA) with Iberia. They codeshare on more than 30 domestic and international routes and cooperate to improve services on the Heathrow-Madrid and Heathrow-Barcelona routes. BA also has three franchise agreements with Loganair in the UK, Sun Air in Scandinavia and Comair in South Africa.

Mergers in a competitive industry

It is very clear from an investigation of this industry and these companies that the network of relationships is complex. It is a highly competitive industry yet many companies cooperate closely across certain routes yet compete fiercely on others. Yet interfirm cooperation and competition in a network setting is something which few other authors have tried to do (Hagberg-Andersson and Tidstrom, 2008). As a result there is a need to look for more evidence in this area and in essence that is the gap this paper hopes to fill. The rationale for merger discussions and why these firms thought it was necessary to go beyond the alliance they already had is another interesting question and in order to answer this question we need to have a greater understanding of mergers in this context. It is argued that the choice between a merger and alliance revolves around choosing the form that best suits the firms need for control versus flexibility (Hoffmann and Schaper-Rinkel, 2002). Those firms with a high need for control, i.e. high transaction-specific investments and uncertainty regarding partner behaviour, should favour mergers. While when flexibility is needed because of changing technologies and dynamic competitive conditions, alliances are the preferred choice (Sawler, 2005). Potential synergies that parties envisage in the mergers and the pursuit of value through merger and the importance of relationships in the process are often discussed in the literature (Madhok and Tallman, 1998).

If we look at this idea of competition and cooperation rationally we almost always assume that the two cannot coexist, how can two parties compete and cooperate at the same time. The question starts to arise are they mutually exclusive as our rational mind would lead us to believe. Essentially our preconception comes from early definitions of competition which tend to see competition as an independent notion, where firms independently strive to achieve their goals in certain markets (Trapido, 2007). However recent research shows that competitive embeddedness can lead to interfirm cooperation. Trapido (2007) in particular shows how the likelihood of cooperation between two firms is positively related to the intensity of competition between the parties in the preceding period.

> "*The competitive embeddedness argument views familiarity and knowledge-based trust, which are greater between competitors than between non-competitors or two randomly selected actors, as the most likely causal links between a history of competition and the emergence of cooperation.*" (Trapido, 2007 p.183)

This is very much in line with network theory and particularly the ARA model, which should therefore allow a better understanding of this complex industry, since network theory recognises that simple dyadic relationships may not always capture the complexity of marketing decision-making or organisational behaviour in complex competitive environments (Hakansson and Snehota 1995). It should also allow a better understanding of the paradox of cooperation and competition in mergers and alliances when explained in this network context.

The network approach expands the traditional economics-oriented view of interorganisational markets to include non-economic bonds between organisations (Easton 1992). It consider the various linkages between various parties as a total exchange system (Hakansson and Snehota 1989; Anderson, Hakansson and Johanson 1994). The network approach places less emphasis on hierarchical organisations and structures, instead recognising that many firms are forming loose alliances that may interconnect at various levels of organisations, with a reciprocal transfer of something of value to each partner (Cook and Emerson 1978; Powell 1990)

Subsequently the AAR suggests that the relationship develops between firms as the activity links, resource ties or actor bonds are formed. The development depends on how each party acts and reacts within the relationship. The actions of the parties over-time cause the relationship to improve or deteriorate. Hakansson and Snehota (1995) maintain that a relationship between two parties is made up of actor bonds, activity links and resource ties. These links ties and bonds exist in different combinations in different relationships and add to the complexity of the relationship concept. The relationship develops as activity links, resource ties and actor bonds are formed (Hakansson & Snehota, 1995). Additionally the activity links within the relationship affect the activity structure of each individual organisation as the relationship develops over time. Hakansson and Snehota (1995) refer to this as "reciprocal conditioning", which they explain as follows:

> *The activity links, resource ties and actor bonds in a relationship between two companies affect the activity structures, the collection of resources and the organisational structures of*

the companies involved. At the same time the activity structures, the collection of resources and the organisational structures of the companies will influence what kinds of links, ties and bonds can develop in a relationship. (Hakansson & Snehota, 1995, p. 42)

In relationship evolution, a change comes about in the activities the parties perform. This change is a result of the adaptation which allows the relationship to evolve. The idea with the AAR model is that as the relationship evolves the activities previously undertaken in isolation become linked, leading to adaptation and eventually interdependence. Linking the activities is a reflection of the need for coordination in relationships and in turn affects how the activities are carried out. This coordination will also have consequences for both the costs and effectiveness of the activities (Hakansson & Snehota, 1995). This concept of activity links will impact on the strength of the relationship.

Companies are often involved in relationships with others where a substantial portion of the activities (in terms of volumes, frequencies, etc.) is performed and thus hold the key to the total costs and performance of the company. The flexibility of the pattern is very much dependent on the way the company has linked up with different counterparts. Even though the activity links are intangible, their effect on the business relationships is often clearly manifest (Hakansson & Snehota, 1995, p.30).

In the analysis of the data that follows it will become evident how this can model can be applied in this context. Essentially Qantas and BA are the actors. The activities consist of the acts of transformation and transaction of resources. R*esources* take account of both intangible and tangible elements such as knowledge, competence, skills, financial resources, aircraft, employees, landing rights etc.

Documentary Analysis

Given the commercial sensitivity of merger talks between two competitors, neither party would openly speak about the progress of the talks or the outcomes. As a researcher attempting to understand exactly what is going on and interpretive the motives of both companies the only choice of method is documentary research. While this may be seen by many to be a limitation of this study, documentary analysis can provide a researcher with rich insights into an area where no other course of analysis is possible because of the contemporary nature of the research area. Indeed Davis and Schneider (2010) advocate the use of documentary evidence where data that explores the intent, purpose and creation of meaning is unavailable through any other source, as is the case with this study.

A document is defined as a written text (Scott 1990); therefore documentary analysis deals with analysing written texts. In literature on research methods the use of documents does get limited coverage (Hargreaves, 2008) however many authors do agree to their value as sources of information (Scott 1990). It should be noted that while documentary analysis may not be common in marketing literature it has been used extensively in archaeology and history (Hodder, 2000).

It is acknowledged that documents will not necessarily tell you the whole story, however Scott (1990) maintains that the story they do tell will be interesting in its' own right. One of the overriding issues with regard to documentary analysis is the quality of the data. Scott (1990) outlines a simple set of criteria to allow researchers assess the quality of the data they are analysing. The four criteria are

1. *Authenticity – Is the evidence genuine and of unquestionable origin?*
2. *Credibility – Is the evidence free from error and distortion?*
3. *Representativeness – Is the evidence typical of its kind and, if not, is the extent of its untypicality known?*

4. *Meaning – Is the evidence clear and comprehensible?*

(Scott, 1990 p.6)

For the purposes of this study the documents analysed were newspaper reports from October 2008 to January 2009, of both Australian and UK published newspapers. Additionally company information was gathered through an analysis of the companies' annual reports. It is well documented that assessing the quality of mass produced newspapers can be an issue. Authenticity can be an issue since newspapers often misprint data and this data may be vital to the study in question. However for the purposes of this study a close examination of the sources used show no obvious misprints or errors, the researcher in this case is confident of the authenticity of the data. Likewise in the case of credibility it is felt that the sources analysed are credible and appear to make no attempt to distort the facts reported. The representativeness issue is one particularly pertinent in historical documentary analysis and not as big a problem in contemporary research. Therefore representativeness is not seen as a problem for this particular study since a wide range of newspapers were easily accessed and the range utilised ensures a representative sample. As Scott (1990) points out the ultimate purpose of documentary analysis is 'to arrive at an understanding of the meaning and significance of what the document contains.' In the case of contemporary documents written in English meaning is easily comprehended. However analysis of the text is open to many interpretations and while these interpretations may often revolve around deciding how to evaluate the text, working out if it fits with a more general understanding etc. Hodder (2000) maintains that the analyst does have 'patterned evidence' which can be evaluated.

Peräkylä (2005) believes that many researchers who use written texts do not follow any predefined protocol in their analysis rather 'by reading and rereading their empirical materials they try to pin down their key themes and, thereby, to draw a picture of the presuppositions and meanings that constitute the cultural world of which the textual material is a specimen'. In line with this the following section will discuss the analysis of the newspaper reports in line with literature as outlined above to identify emerging themes and gain an understanding of the merger talks between Qantas and BA.

Merger Talk

As previously stated it all began in late October 2008 when the outgoing Qantas CEO, Geoff Dixon, in his last TV interview, said that the airline industry worldwide is too fragmented and there is a need for airlines to merge to maintain competitive. In particular he foreshadowed a rash of consolidations to weather the raising fuel prices and economic downturn. Although he did state that Qantas were "well-placed" to survive the aviation crisis, talking particularly in terms of the financial strength of the airline and it competitive position.

In the weeks that followed this interview, speculation ran wild with many newspaper reports discussing Qantas' merger plot. On 12/11/09 speculation increased as Qantas appointed David Epstein to the newly created role of executive general manager government and corporate affairs. The reports indicated that his brief was to get the restrictive Qantas Sales Act amended (the act which states that no group of airlines can have more than a 35% share of Qantas). It was believed that this would then allow Qantas to merge with another carrier. At the same time the press in the UK was closely watching BA as competition in European skies hotted up when Lufthansa took control of BMI and announced plans to compete more aggressively with BA. No mention in either country up to this point about merger talks. Dixon however was continuing to discuss consolidation in the industry. In one interview he said he was ready to go and "leave Joyce in charge for the challenges ahead" including what he sees as "inevitable consolidation" (Sunday Telegraph 16/11/08).

Finally on December 2nd BA announced that merger talks with Qantas were well advanced. It appears from reports that talks began as early as August 2008. From this point up until December

18th all reports revolved around two questions, 1) could this merger take place and 2) should this merger take place. The following discussion will address themes that emerged over this 16 days period and beyond.

In the initial few days most reports concentrated on the facts and figures, this merger if it went ahead would create one of the biggest airlines in the world. The merger was comparable in value to that of Air France/KLM. It would potentially cushion both airlines against the global financial crisis and economic downturn, which has seen the demise of 30 airlines in the last 12 months. There were however major obstacles which needed to be overcome most notably the foreign ownership issues in Australia. How the entity would be structured and who would have the largest holding were seen as big issues.

Much discussion revolved around the relative strengths of both parties, Qantas was clearly in a stronger position, given BA's weaker balance sheet and major pension liabilities. Qantas at the time were seen as one the strongest airlines worldwide with a "robust cash balance" following the "ruthless attention" they had paid to its cost base.
Despite the obstacles many commentators saw the positives in synergies, which could be achieved through this merger. Both airlines had largely compatible fleets, which would lead to maintenance and engineering synergies. The potential to increase sales through joint marketing efforts was also seen as a big plus. Their loyalty programs were compatible as both were part of oneworld alliance. Overall most commentators say them becoming a formidable force in the airline industry, allowing them to cooperate on major routes on pricing, marketing and scheduling.

One obvious issue that arose in reports was how these synergies in marketing could be achieved with two brands, as it appears the discussion involved both maintaining their existing brand. It was clear that the brands, which identify them as national carriers would have to be maintained or government support would not be forthcoming. As such it seemed that this merger would be a dual listed company (DLC) merger to allow the brands to be kept. Indeed it was summed up beautifully early on

> *The complexities of merging the two carriers, the involvements of governments, the inevitable opportunism from rival carriers, the potential for a third party to gate crash the discussions and the "social issues" that are elevated in a DLC would be intense in a merger of two national carriers/icons means there is no certainty that the discussion will lead to a deal"*
> Business Spectator (3/12/08)

By the 8/12/08 questions were being asked as to why there was a need for the merger. Many of the synergies mentioned previously were available to them via the JSA. Australian reports especially were asking did Qantas really need this and were BA just looking to be bailed out.

On 9/12/08 Alan Joyce the new CEO was stating that the merger was not a "fit accompli". He cited pension liabilities of BA as a major issue. He clearly stated that any merger must create value to Qantas shareholder and he said that Qantas were interested in exploring a link with an Asian carrier. By 10/12/08 most headlines were focussed on the major hurdles for this merger. But when the Qantas board gave the go-ahead for talks to continue on 12/12/08 much of the discussions turned to the positives of the merger again. Most reports were again back to the fact that given the turbulence in the industry the time was ripe for a merger. By 17/12/08 most reports said that talks would continue in the new year, but at the same time Malaysian airlines was emerging as a possible merger partner for Qantas, while BA continued talks with Iberia.

Then on 18/12/08 Willie Walsh the BA chief reiterated that the merger faced many hurdles, again fuelling much speculation that it would not go ahead. It was announced on 19/12/08 that Qantas and BA had failed to reach agreement and that merger talks were off. It was reported that the deal fell apart because Qantas would not agree on a merger of equals. Qantas wanted 51% as the party with larger market value but BA want a 50/50 merger. It is also thought that this ratio was demanded by Qantas to appease foreign ownership restrictions. Statements released by both companies said that key commercial terms could not be resolved. Most reports commented again on the parallel talks BA had throughout these merger talks with Iberia and the dissatisfaction this caused. Qantas had apparently made it clear from the outset that a three-way deal was not an option.

Conclusion

In undertaking this documentary analysis it seems clear from the start that many reports felt this deal was doomed. The stumbling blocks were considerable and it appears outweighed any synergies that might have been achieved. Qantas' position of strength clearly played a major role in the outcome. Ultimately it came down to status and while Trapido (2007) proves that the likelihood of cooperation between two firms is positively related to the intensity of competition between the parties in the preceding period, he also points out that this can be negatively impacted by status, in other words neither party wanted to be seen to be giving in, especially Qantas who felt they were the strongest party.

The government restrictions on foreign ownership in airlines in both countries was also a major issue and one as pointed out earlier that causes problems for many airlines. The nature of regulation in this industry will continue to be an obstacle both to competition and cooperation. BA's ongoing negotiations with Iberia also did not bode well for this merger after an ultimatum from Qantas was ignored.

So while looking at the current economic climate it appears that the timing was right for this merger, it appears that the obstacles could not be overcome. Interestingly though in newspaper reports immediately after the merger was called off, Qantas were rumoured to be pursuing a merger with Malaysian Airlines and talks between BA and Iberia were breaking down. Watch this space!

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