

AIRLINES Airlines continue to battle against the downturn

BY SELINA HARRISON



During the last 18 months, the airline sector has experienced considerable distress. The bankruptcy of Italy's national carrier Alitalia, in August 2008, was a low point in a turbulent period for global airlines, many of which announced heavy losses and undertook operational restructuring initiatives. Prior to its bankruptcy filing, Alitalia had been losing €2m a day. The company was eventually acquired by Compagnia Aerea Italiana for \$1.33bn in November 2008 and merged with fellow Italian carrier Air One. This is one example of a successful restructuring, but other companies continue to experience difficulties.

In recent months, Japan Airlines (JAL) went bankrupt, British Airways (BA) implemented drastic cost-cutting measures and American Airlines reported heavy losses. "The issues that are leading airlines towards insolvency, at present, are the same issues that traditionally have done so," explains David R. Seligman, a partner at Kirkland & Ellis, LLP. "The overwhelming drivers of the current malaise are low demand, high fixed costs, high legacy costs – including wage, work rule, health and retirement benefits – as well as greater competition and price transparency from internet ticketing," he says. Other exogenous factors which have impacted the profitability of the

airline sector in recent years include the fear of terrorism or health epidemics. Airport charges and oil prices have also contributed to financial hardship in the airline sector. "The International Air Transport Association (IATA) estimated net losses for the airline sector, during 2009, at \$9.4bn with a surge in fuel prices to more than 50 percent of many airlines' operating costs," says Laura Pierallini, a partner at Studio Legale Pierallini.

Improved outlook

However, it appears that market conditions for the airline sector are improving. In March 2010, the IATA halved global airlines losses forecast for the year to \$2.8bn, from a previous \$5.6bn loss forecast in December 2009. The IATA explains this improvement has largely been driven by a much stronger recovery in demand, demonstrated by year-end gains that continued into the first months of 2010. This is particularly true for Latin American and Asia Pacific airlines, whose carriers reported an increase in international passenger demand of 11 percent and 6.5 percent respectively in January, compared to a 2.1 percent and 3.1 percent increase in passenger gains for North American and European airlines during the same month. Overall, the IATA forecasts global passenger demand to increase by 5.6

percent this year, compared to the 2.9 percent decline witnessed in 2009.

In the meantime, cargo demand is also beginning to recover. The IATA has forecast growth of 12 percent this year, compared to an 11.1 percent decline in demand last year. As a result, the association expects airline revenues to rise to \$522bn during 2010, up from \$479bn last year. These early signs of optimism are good news for the industry. However, the crisis is not over and IATA's director general and CEO Giovanni Bisignani has warned that the airline sector should remain cautious, as risks will likely persist. With improved economic conditions, the price of oil will also increase – in fact, the IATA forecasts that the average price of oil will reach \$79 per barrel in 2010, up from an average of \$62 per barrel in 2009. This rise in oil prices, combined with increased passenger numbers, will add \$19bn to the industry's fuel bill, expected to be at around \$132bn this year. This represents 26 percent of the industry's operating costs, up from 24 percent in 2009. To add to the not-so-good news, the IATA also reports that during the last two years the airline sector lost at least three years of growth. Therefore, any recovery the airline industry witnesses will be profitless until at least 2011. As the airline sector is expected to continue battling through the economic downturn, it is no surprise that so many airlines are launching aggressive cost-cutting restructuring to remain profitable or avoid bankruptcy.

After reporting a pre-tax loss of £292m for the six months to the end of September 2009, BA announced a reduction in employee working hours and a two-year pay freeze, which marked the beginning of a full-blown dispute with its employees. The Unite union accused the airline of trying to impose new working practices and therefore submitted its own cost-cutting proposals, which included a 2.6 percent salary reduction of BA employees. But talks collapsed when the carrier rejected the union's offer, saying it fell "significantly short" of the savings it sought. This resulted in BA's cabin crew striking for several days in March 2010, at a cost of over £100m to BA. ▶▶

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While some airlines are battling to cut costs, others simply collapsed. The bankruptcy of Japan's national airline JAL this January marked one of the biggest corporate bankruptcies the country has witnessed. Unable to manage its \$25.6bn debt loan, JAL was forced to restructure under bankruptcy protection, resulting in the loss of 15,600 jobs, a delisting from the Tokyo Stock Exchange and the resignation of all of its board members. The Japanese government backed the carrier's turnaround, injecting ¥300bn (\$3.3bn) into the company and smoothing the process over with a ¥600bn credit line and waiving ¥730bn in debts.

These are just two of the most high-profile cases of carriers experiencing financial difficulty. Besides restructuring through bankruptcy, it is clear that in order to navigate the downturn most airlines will have to adjust their current business models, allowing them to adapt to changing markets and remain profitable. This is essential as the sector currently lacks the flexibility necessary to adapt to changing financial environments, believes Mr Seligman. "Many airlines are restricted by labour contracts, intensive national and local government regulations, aircraft lease and financing agreements, as well as supply and other contracts that limit their ability to quickly restructure their fleet, labour force, and other operations to adapt to changing circumstances. Furthermore, whether there can

ever be an airline with a business model sufficiently nimble to allow it to react in real time to changing market events is questionable," he continues, adding, however, that one way to for airlines to adapt is to reduce supply and consolidate.

Mergers and alliances

Mergers and alliances in the airline sector provide a number of benefits, allowing carriers to increase incremental traffic, revenue and profit, and to extend network reach with little increase in assets and operating costs. M&A and alliances also allow airlines to circumvent difficulties by obtaining international route authority and to defend airlines against aggression by other mega-carriers and alliance groups. However, while mergers are often difficult to implement from a regulatory and political perspective, the grouping of carriers alliances, code-share arrangements, and joint marketing agreements have gained strategic importance as they help airlines to achieve some of the benefits and economies on the scale of a merger without the corresponding legal and practical difficulties. "The global economic downturn has forced airlines to try to find new models of business, including the set up of low-cost airlines, mergers and consolidation. The issue is not only operational or financial, but a combination of both – and in the current environment, joining an alliance has become almost a prerequisite for smaller airlines to enable them to remain competitive, particularly in liberalised markets," says Ms Pierallini. However, it is not just smaller airlines that are using alliances to their advantage. In light of the collapse of JAL, Delta Air Lines of the SkyTeam alliance was keen for the Japanese airline to join its partnership to open access to more routes, although ultimately JAL decided to enter a joint marketing arrangement with American Airlines.

However, while alliance benefits are undeniable, planning, negotiating and implementing entry into a global alliance can be time-consuming and the outcome is not always guaranteed. "As alliances have grown, they have become increasingly selective about new partners and are imposing stringent requirements for entry. Bilateral code-sharing with partners in different geographic regions can be a viable alternative to global alliance membership, providing many of the same benefits," says Ms Pierallini. Another aspect

to be taken into consideration is related to the burdens and restrictions that airlines can face in setting up alliances and code share. These agreements can sometimes pose competition concerns, meaning antitrust authorities can impose restrictions against them.

For example, last month European antitrust regulators imposed some requirements for the approval of the OneWorld alliance expansion between BA, America Airlines and Iberia. Following BA's near-complete merger with Iberia, the airlines were told by the European Commission that they should cede landing and takeoff slots at airports serving London and New York, in order to lower barriers to entry for other airlines flying from those destinations. The Commission began an investigation into the expansion of the alliance nearly a year ago after worries that combining the airlines' services would limit competition and raise fares on some of the world's most frequently travelled routes. This is actually the third attempt by BA and America Airlines to partner, after previous efforts in 1997 and 2002 were abandoned on antitrust grounds. However, in recent years, the market for transatlantic air travel has changed and other airlines, including Continental, Delta and BMI, now offer services to these destinations. As a result, regulators are now demanding fewer concessions of slots – only six. The Commission has given interested parties until 10 April to comment on the settlement, a sign that the regulator considers the offer satisfactory.

While alliances are a major trend in the airline sector, cross-border consolidation is currently very limited. In the IATA financial forecast, Giovanni Bisignani warned that restrictions on the bilateral system is preventing the kind of cross-border consolidation that other industries, such as pharmaceuticals or telecoms, have been able to pursue. As a result, airlines are battling the challenges of the financial crisis without the benefit of this important tool, making restructuring in the sector even more difficult. However, some experts believe that the recovery of the airline industry depends on core factors specific to carriers. "For decades, airlines have consistently tried to be more profitable – unsuccessfully. Every airline has tried to implement operational, financial and every other solution you can think of with very little long-term, measured, consistent success. However, part of it may be inherent in the airline industry, as many airlines end up

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“serving essentially utility functions in our society,” observes Mr Seligman.

Overall it looks like a slow road to recovery for the airline sector. The IATA has forecast that this year the airline sector would continue to see improving demand from both passengers and cargo. While Asia Pacific and Latin America airlines will lead the sector's recovery, another trend will be

the continued implementation of alliances, such as the United-Continental-ANA alliance and the American-JAL alliance, which are both under US antitrust review. However, the IATA believes that a structural adjustment of the industry is key to its recovery. In November 2009, the association drafted the Agenda for Freedom document, an initiative signed by seven governments

to support the liberalisation of market access, pricing and ownership of airlines. The IATA believes liberalising the market would boost its recovery in the US and Europe, which represent 60 percent of global aviation activity. However, until governments abandon restrictions on cross-border deals, experts believe that a full recovery will not happen soon in developed markets. ■



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labour and regulatory advice, (iv) financial and corporate assistance, (v) international work for the airlines' handling companies, (vi) representation of manufacturers and Italian and foreign lenders in connection with the acquisition, disposition and operation of commercial aircraft, including purchase, lease, charters and financings for such transactions, (vii) regulatory work, including advisory services and assistance, planning and compliance in connection with representation before governmental agencies, having continuous contacts with the Civil Aviation Authorities, mainly in Italy and EU, but also abroad, (viii) advising to international leasing companies and financiers in their aircraft business in Italy, (iv) registration and de-registration of aircraft in Italy. Laura Pierallini represents Italian carriers in their contacts with the Italian Government and Ministry of Transportation to simplify registration and de-registration procedure and has assisted the two most recent IPO of airlines in the Italian market as well as M&A of domestic airlines by foreign airlines. Laura Pierallini has acted as counsel to administrators and major Italian airlines in extraordinary administration and has advised an Italian airline, as first European carrier, in the agreements with Boeing in respect

of four Boeing B787 aircraft equipped with Rolls-Royce engines. She is the adviser to the Italian Association of Air Transport Carriers (Assaereo). She has attended a number of conferences on aviation, presenting speeches at various Italian and international symposium. She contributed books and articles in various publications, such as *Getting the Deal Through - Air Transport - Italian Jurisdiction* (Global Competition Review 2006, 2007, 2008 and 2009); *Aircraft Finance and Aircraft Liens*; *A New Prescriptive Intervention Towards the Homogenization of the Air Carrier Liability*; *The Role of the Airport Manager Package tours*; *The Legislative Decree No.111/1995: Effects on Relations Between Tour Operators and Travel Agents*; *Travels, Holidays, Package tours, Denied Boarding and Cancellation: New Fines for Airlines*. She is recommended as leading lawyer in various magazines and guides, such as *Top Legal*, *Aircraft Financing*, *Getting the Deal Through - Air Transport*, *International Law Office - Aviation*, *The International Who's Who of Aviation Lawyers*, *Corporate UK and World's Leading Aviation Lawyers - Expert Guides*. The Firm has been awarded as "aviation law firm of the year", by *ACQ Finance Magazine*. Laura Pierallini is a member of L2B Aviation Group, IAWA and EALA.