

The Study of Airline Merger and Acquisition in the Greater China Area

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Abstract

The Asian financial crisis in the late 20th century has some long lasting effect on the air transportation industry in Asia, especially in the Great China Area. Starting from 1998, airlines in both China and Taiwan suffered some serious financial losses due to the diminishing travel demand caused by the economic recession. Airlines were forced to cut price to attract passengers and hence crashed the market discipline. A number of airline mergers and acquisitions were then driven by the markets and the governments. After China and Taiwan have both entered the World Trade Organization, some mega-merging cases were finalized in late 2002 for better fitting the world's aviation competitions.

This paper reviews the nine merging and acquiring cases in the Great China Area in the past 5 years. Almost all the airlines in the area were involved. The new groups of airlines and the survival airlines are introduced. Market response to the airline mergers will also be examined. A general look over the performance of the new airlines will be discussed. And the future of the market will also be analyzed. Finally, the practices and the impacts of current inter-state mergers in the Great China Area will be examined. The study has expected a highly concentrated domestic market in both China and Taiwan. Each of the market will be dominated by three major airline groups of their own. Cross-holding equity within these 6 leading aviation groups would also be possible after further deregulations.

1. Introduction: The History of the Airline Industry in the Greater China Area

The airline industry in China can be traced back to the late 19th century. However, there is not any single carrier that can survive for over a hundred years. The current aviation industrial structure was established during the 1930s to 1940s when both Cathay Pacific and China National Aviation Corporation (CNAC) were established. These two carriers are still some most important airline groups in the Greater China Area today. Cathay Pacific was set up in 1946 in Shanghai as a private business, while CNAC was setup in 1930 in Nanjing as a state enterprise. The role of CNAC is quite embarrassing after the ROC regime was turned to PRC in 1949. Some pilots threw their lot in the communists and flew their aircraft to Beijing. These pilots and aircraft were then become the basis of the following monopoly air carrier in China, the Civil Aviation Administration of China. CAAC is the administrative bureau of civil aviation. Following the Soviet bureaucratic structure, it was also providing the monopolistic air transportation service. The carrier of bureau has operated for over 30 years until the first deregulation act made in 1985. The deregulation policy, which should be considered as a revolution to decompose the aviation industry, was mainly for the purpose of separating business sector from administrative bureau. By then, some new state enterprises were created, and some regional or provincial carriers were also introduced. The entire aviation industry of China has been expended to 26 carriers within a few years. A brand new era for the aviation industry was come, not only because of the number of carriers was increased, but also the efficiency and service quality was improved.

On the other hand, by losing all the aircraft during the civil war, the ROC regime which retreated to Taiwan in 1949 was not able to run aviation business anymore. The state owned aircraft grounded in Hong Kong was then sold to General Claire Lee Chennault, the leader of Flying Tigers in China, in a very affordable price before the property rights of these aircraft could be transferred to PRC. General Chennault used these aircraft established Civil Air Transport (CAT) in Taiwan, while other members of Flying Tigers established Flying Tiger Line in US. CAT went bankrupt a few years' after the Vietnam War. The China Airline then took over their business in Taiwan. Established in 1959, China Airlines was the last one of the first three airlines set up in the 1950s. All the three carriers are still operating today, regardless of their heavy losses. After China Airlines was set up, an entry barrier of air transportation industry was successfully built to keep competitors away from the market for over 30 years. In the early 1990s, Eva Airways broke the barrier by modifying the aviation law through Legislators supporting

them, probably also supported by them. A deregulation policy was then made to welcome new players in the market. Within a few years, the number of airlines in Taiwan has expanded from 3 to 9. Private sectors were investing huge amount of money because the aviation industry under protection was a real profit one.

Meanwhile, new carriers in both Hong Kong and Macau were also introduced during the mid of 1980s and 1990s. Dragon air, the second airline of Hong Kong, was established in 1985 focusing mainly on the air transportation market of China. 10 years after the Dragon air, Macau has also launched a new airport with a new airline, the Air Macau. Air Macau is also an airline of Greater China market. Although these two airlines have big similarities in product positioning, yet the huge demand across the Taiwan Strait has still made these two carriers profitable during the past years.

2. Post-deregulation Effect: Merger and Acquisition

It seemed like most nations having deregulation policy towards aviation industry have experienced some similar transformation of the market structure after deregulation. In the first phase of deregulation, numerous competitors are appearing soon after the entry barrier is broken. Nonetheless, airlines have big sunk cost. Deregulation policy has made airliners easy to get in, but hard to get out. This is just one worst market structure can be found in some basic marketing theories. Deregulation policy was based on the belief of market mechanism, but the mechanism has also defaulted the economic effect of deregulation. As most marketers' prediction, airline business soon turned non-profitable after deregulation. Any change from the operating environment will cause serious damage of the entire industry. In the past 20 years, lots of mega-carriers went bankrupt in US and Europe, and a number of airline mergers and acquisitions occurred each and every year. Any single political or economic factor, including terror attacks, war, even economic recession or business competition, could have huge impacts on airlines' operations. Not surprisingly, airlines in the Greater China Area have to face the same problem.

The Asian financial crisis in the end of 20th century was one last, probably the most important factor to encourage airline mergers in the great China area. Although none of the carriers went bankruptcy, most carriers were losing big money. The idea of airline mergers was than proposed by some economists in China. Long before Asian financial Crisis, scholars in Taiwan have also encouraged airline merger to reduce the negative effects of deregulation. Together with some acquisitions, we have concluded 7 M&A

cases after 1990s. These cases are:

1. Air China Group:

Air China Group was a combination of 3 different airlines: Air China, China National Aviation Corporation, and China Southeast airline. Air China was the flag carrier, it is still the one and only flag carrier after mergers. One interesting fact in this group is the role of CNAC, the China National Aviation Corporation. It was and still is the stock holding company of both Dragon Air, Air China, and one small regional carrier Zhejiang airline. That is to say, Air China Group nowadays controls 5 airlines altogether. The total asset of Air China Group is 57.3 billion RMB, approximately 7 billion US dollars. They have 119 aircraft and 307 links in total. The number of employees is now 22960.

2. China Eastern Airline Group:

China Eastern Airline Group is based in Shanghai, one attractive and energetic city with fastest growing economy in China. In addition to the original China Eastern Airline, the group also integrated Yunnan Airline and China Northwest Airline. The new China Eastern Airline Group is now an airline with 47.3 RMB billion assets, 142 aircraft, 386 links, and 25000 employees.

3. China Southern Airline Group:

China Southern Airline was the first Chinese airline that went public in Hong Kong and New York. Based in Guangzhou, China Southern Airline has enjoyed the successful economic reform during the 1980s and 1990s. Although the focus of China economy has moved up to Shanghai and nearby areas, Southern China has still been benefited, and so has the China Southern Airline. It was the most efficient airline in the past 20 decades. The group integrated China Southern Airline, China Northern Airline, and Xinjiang Airline. The New China Southern airlines is having 50.1 billion RMB assets, 180 aircraft, 666 operating links, and 342686 employees.

4. China Airlines Group:

Across the Taiwan Strait, there are also some merging cases of airlines. The China airlines, which holds 100% of mandarin airlines, is one biggest aviation group in Taiwan. In the aviation market, there is no merging record of this carrier, because China Airlines has only acquiring some domestic carriers instead of merging. Currently

China Airlines is still holding some minor shares of Far Eastern Air Transport, one most important carrier in the domestic market. China Airlines have also had over 90% shares of Formosa Airline, one disappeared carrier in the market.

5. Mandarin Airline and Formosa Airline

Both these two airlines are belonging to China Airlines. China Airlines is holding 100% of Mandarin and majority shares of Formosa. The functions of Mandarin and Formosa were divided into international brand and domestic one. The reason to set up Mandarin was because of the too-sensitive role of flag carrier in some specific regions; and the reason to hold Formosa was because of the allocation of time slots in the very congested Taipei airport during the 1990s. However, the Formosa Airline was bad at the air safety records. Fatal accidents happened year after year. Finally China Airlines decided to terminate the operation of Formosa, but still want to hold the traffic rights in some domestic links. The group asked Mandarin to merge Formosa in 2000 as a result.

6. Eva Air Group:

Eva Air is the airline of Evergreen Group, one of the major marine liner groups in the world. In the late 1980s, Evergreen decided to expand their business from marine liner to one fully integrated logistic empire, so they decided to break the entry barrier of air transportation law in Taiwan, also initiated some ground transportation services. The Eva Air was successfully established in the early 1990s. They also acquire one small carrier in Taiwan to serve the domestic market. This airline was Makung Airline, which turned into Uni Airways afterwards.

7. Uni Airways Mergers

Uni Airways was the former Makung airline acquired by Eva Air. Evergreen decided to transfer the property of the carrier to one of its sub-company, the Uni Liner. So the name of Makung was then changed in the mid 1990s to Uni Airways. To enhance the competition power in the domestic market, Eva decided to acquire 2 other small carriers in Taiwan: The Taiwan Airways and Great China Airways. Soon after Asian financial crisis, Evergreen Group has decided to cut cost and condensed the business scale. All 3 domestic carriers were merged. The existing airlines has chosen to be the Uni Airways.

8. Hainan Airlines

The most interesting case of acquiring the airlines in the Great China Area should be

the Hainan Airlines. Hainan Airline is the first airlines trading both A shares and B shares in the China Stock Market. The critical ratio of equity was acquired by private sectors during the Asian financial crisis. Some other airlines were also acquired in 2002 while major state-owned airlines group were restructuring. Nowadays Hainan airlines group has been the biggest private owned carrier in China. Deer Jet Company Ltd., Chang'an Airlines Company Ltd., Shanxi Airlines, China Xinhua Airlines Company Ltd., and Yangtze River Express Company are all under control of Hainan Airlines. The entire group is now holding 80 aircraft in total.

3. Cross Border Acquisitions

In addition to the local merger and acquisition cases discussed above, cross border acquisitions are also easy to find in recent years. Although the political relationship within the Greater China Area is complex, cross border equity holding in this area is still popular. All the four states and regions have involved such sensitive business activities, but all maintain very low profile. Four major cross border acquisitions are:

(1). China on Hong Kong:

CNAC is now the biggest share holder of Dragon Air. Nonetheless, the history of taking these shares of Dragon Air from Cathay Pacific was an unpleasant experience. In 1995, Eva Air in Taiwan has again broken the market entry barrier and successfully penetrated the monopolistic market between Taiwan and Hong Kong. In order to balance the pressure from two large carriers from Taiwan, China has express their willingness to join the market, and asked Hong Kong adding one more carrier to serve the Hong Kong-Taiwan market. The only choice was Dragon Air who was controlled by Cathay Pacific at the time. China then forced Cathay Pacific to give up certain shares of Dragon Air to keep Cathay's capacity in the world's busiest air link. CNAC finally took over Dragon Air, and the economic power of China has started to play a role in Hong Kong's air transportation soon after this successful acquisition.

(2). China on Macau:

CNAC is also the biggest share holder of Air Macau since establishment in 1995. This is about the same time when CNAC took over Dragon Air. But since Macau is less sensitive in both political and economic affairs, also because CNAC has involved since very beginning, the process of holding Air Macau by CNAC is much

easier than holding Dragon Air in Hong Kong. Lacking direct services between Taiwan and China have given Hong Kong and Macau one great niche market to survive, both Air Macau and Dragon are doing quite well in the Greater China Market, thus make CNAC profitable in the past decade.

(3). Taiwan on Macau:

The relationship between Hong Kong and China or Macau and China has already been confirmed in the late 1990s. Both Hong Kong and Macau are now the Special Administrative Region (SAR) of China, but it's not yet clear whether Taiwan will accept this arrangement or not. Obviously, any merger or acquisition between Taiwan and the rest of China can be very sensitive. Nonetheless, Eva Air has done a great job in acquiring certain shares of Air Macau. Eva acquired 10% shares of Air Macau from the former colony Portugal government and business in Macau. As Portuguese may withdraw from Macau entirely, Eva Air could probably acquire more shares in the future, hence made them the second biggest power in Air Macau.

(4). Taiwan on China:

The most difficult acquisition should be acquiring firms across the Taiwan Strait. Even so we can still find one successful story of China Airlines and China Eastern Airline Group. China Airlines has successful acquired 25% of China Cargo Airlines, one of the two cargo airlines in this region in 2002. The share was transferred from China Eastern Airline Group, one of the only two share holder of China Cargo Airline. This acquisition has been suspended for over 12 months to get the approval from the administrations of both sides. This case is even more sensitive than Eva Air acquired Air Macau since the relationship between Taiwan and China are still unstable.

Figure 1 illustrates the relationship of the current airlines within the Greater China Area. Both local and cross border airline mergers and acquisitions are included. They are, however, only existing M&A cases listed in this chart. Potential M&A cases are not yet introduced. Future integration in 2 domestic carriers in Taiwan is likely to happen, while some individual local carriers in China are initiating strategic alliances to increase their competition power. These possible horizontal integrations are concluded in Table 1.

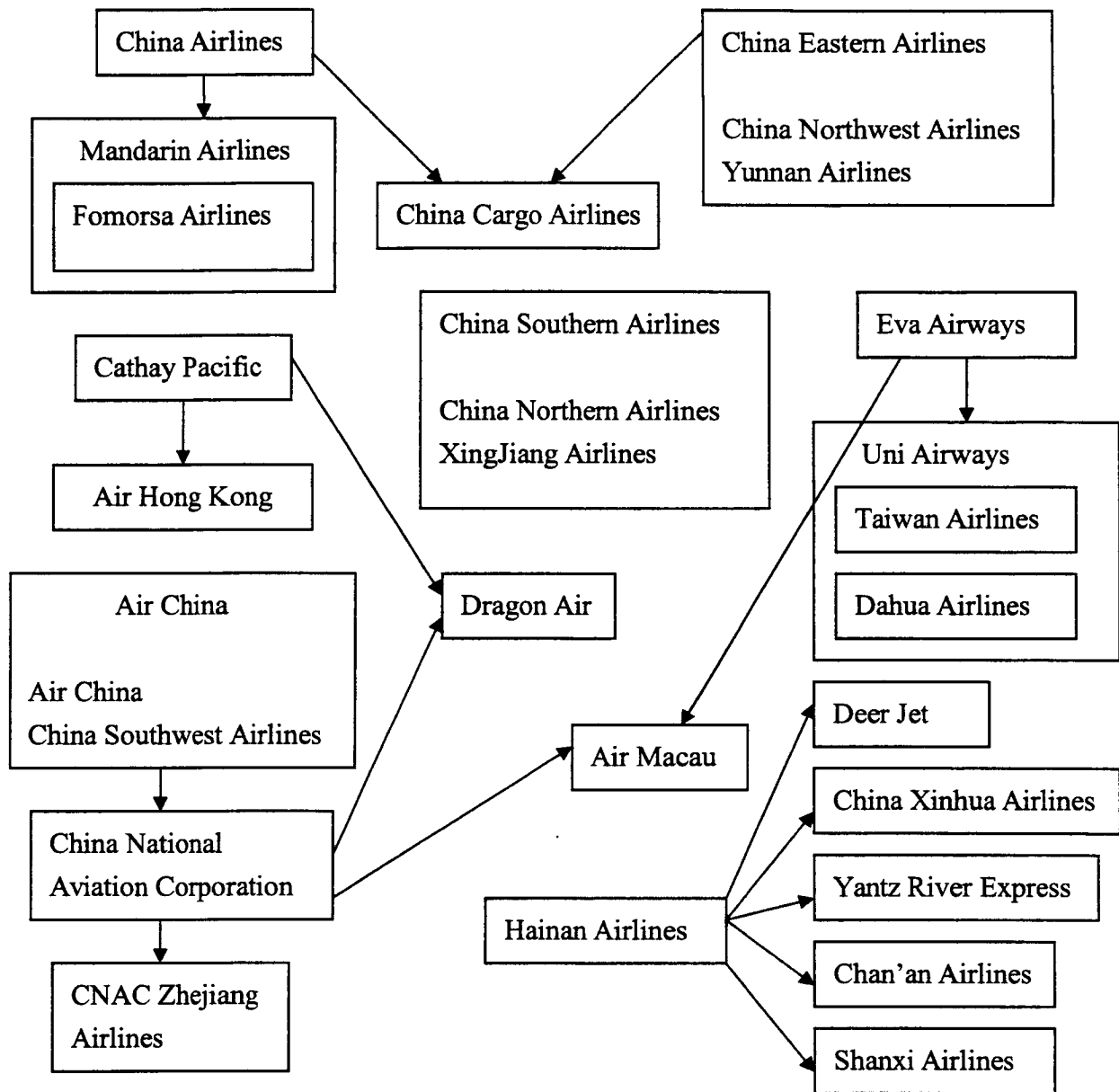


FIGURE 1 Relationship of Airlines in the Greater China Area

Table 1 Possible Airline Integration in the Future

Involving Carriers	Description
Far Eastern Air Transport TransAsia Airways	Major share holders are seeking the possibility to integrate these two carriers in Taiwan
China Postal Airlines, Shanghai Airlines, Shandong Airlines, Wuhan Airlines Sichuan Airlines, Shenzhen Airlines	Carriers in China out of 3 major airline groups and Hainan Airline group sought strategic alliance

4. Problems of Airline Mergers

Since the merging and acquiring activities occurred at a very high frequency, some problems can easily be observed during these transitions periods. Operational, organizational, managerial, and financial problems are the most serious ones which includes:

1. Performance after mergers and acquisitions

One most important issue of M&A is evaluating the performance of merging and acquiring company after M&A. A number of researches are focusing on this issue, but never on the airline industry. Some indexes of both production and finance are developed to measure the performance between pre-M&A and post-M&A. Stock price, passenger-mile, ton-mile, labor and capital productivity are all commonly used in evaluating airlines' performance. Nevertheless, the airline M&A in the Greater China Area is still too new to have these comparative analysis. Within one year or two, these numerical tests are valuable topics in both academic researches and practical studies.

2. Managerial and culture conflicts

Any kind of mergers will lead to some organizational conflicts between merged and merging company. This is also easy to see in the airline industry. The most common managerial conflicts are usually happening during organization restructuring. Job rotation is a must and hence force airline employees moving to some distant workplaces. Moreover, the merged airline would easily form a sub-organization against the merging airline. The parties within an organization, or Paixi in Chinese

translation, has then become one inevitable bi-product of airline merging. Conflicts from different organization culture could also be very serious especially within the merger case of regional niche market carriers. Each of the carrier is a local monopoly in their market, and is adopted to their local environment. Merged to some other carriers is definitely crushing the value system and the market niche of their own.

3. Integration synergies of merger and acquisitions

Whether or not M&A can create better performance on some production and financial indexes are still unknown, but the synergy of airline merging can be examined at the very early stage. Apparently, synergy does exist in some of these airline mergers and acquisitions, especially those cross state cases. For instance, China Airlines of Taiwan acquiring shares of China Cargo Airlines does help China Airlines in expanding their cargo service network to some place they currently cannot reach. Eva Air acquiring Air Macau may possibly create open jaw service routes in across Taiwan Strait, or also extend their service to China through code sharing and 5th freedom. These are all increasing their competition power in the market. On the other hand, less synergy can be found in the local airline M&A in both China and Taiwan.

4. Anti-trust and fair trade issues

The antitrust issue of airline merger and acquisition is always highly concerned by related government bureaus throughout the world. Some famous cases in both Europe and US have indicated one general rule of airline M&A: overlapping markets between merged and merging carriers is harmful to social welfare. This index is always examined with detail. However, airline mergers were encouraged in Taiwan, and the cases were even directed by the government in China. Related bureaus in both places are not able to evaluate these cases but only approve them. Some complaints have already been found during the transition period. Still, this is one important issue left behind these M&A activities.

5. Conclusion: Forming the Greater China Alliance

The airline mergers and acquisitions in the Greater China Area in the past few years has lead to one much more concentrate market in this area. Six major airline groups, including Air China Group, China Eastern Airlines Group, China Southern Airlines Group, Hainan Airlines Group, China Airlines Group, Evergreen Group are established.

Potentially there are two other airline group can be organized, but the total number of airline groups would probably stayed in 6 to 7. If cross border mergers can be more accepted by the modification of aviation regulations in both sides, further integration can still be expected. The interstate transportation demands have successfully made the market between Taiwan and Hong Kong the biggest one in the world. Since Chinese is now controlling the market, cross holding equity in both Hong Kong and Macau by either Taiwan or China could be a possible and acceptable norm. Future M&A across the Taiwan Strait would probably be initiated through the integration of Hong Kong and Macau aviation market.

Whether these mergers and acquisitions are helpful or not to the airlines' operations is still unknown, but the decreasing number of competitors is at least a good news to those survival airlines, especially large scale carriers. In the past few years, Asian financial crisis, post September 11 recession, and recent SARS disease outbreaks have all created considerable operation deficit of some carriers in this area. Less competition may enhance the existing airlines' market power, hence make airline a profitable business in the future. Small carriers can now serve in a niche market only. New route allocation regulations in China have even asked small carriers to withdraw from the hub airports. Taiwan is also giving the rights of trunk line operations to the major carriers only. These changes may also encourage new airline M&A in the future because airliners will seek better stakes in the market. All these happening changes is worth watching. Future studies may focus on these interesting and important facts to find out both the short term and long term effects of M&A. Numerical analysis using some financial or production indexes should also be applied in the future if statistical data finally available.

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