Returning Back to Action? The US Airline Industry Analysis

Introduction

The US airline industry, following two years of devastation and billions of dollars of losses due to the pandemic, appears to be springing back to life. Passenger numbers are returning to pre-pandemic levels and firms are starting to become profitable once again. More interestingly, airlines appear to again be on the quest for mergers and consolidation to cut costs and increase market power in their competitive industry. JetBlue and Frontier Airways are in a bidding contest for Spirit Airlines, whilst the former, together with other airlines, is forming a code-sharing agreement, which the US department has sued to block. The high current level of activity in the industry, therefore, merits a deeper look.

US Airline Industry Analysis

The commercial airline business in the US is notoriously tough. The bargaining power of buyers is profoundly high, as there are several airlines competing in the industry, meaning there almost always is an alternative airline to fly with. Similarly, there is a high threat of entry into the market and strong rivalry between existing competitors. Thus, we can expect the airline industry to not be very profitable, meaning firms must take differentiating approaches to do well financially.

The first thing to note is that the overall industry is dominated by a small number of players. American Airlines, United Airlines and Delta, together with Southwest, control a 65% market share. Amongst these firms, American is the largest with an 18.5% share, followed by Southwest (17.7%), Delta (16.3%) and United (12.7%). In general, the market can be divided into three groups of firms.

One is the group that focuses on product differentiation to attract customers, meaning they try to improve the customer experience to the extent that they will pay more for the flight than they could with other airlines. In this group are American, Delta and United. Then, we have the group of airlines that are laser-focused on offering the lowest price. They try to induce customers by being the cheapest option to fly. Firms operating in this segment include Southwest, Frontier and Spirit Airlines. Finally, we have those airlines operating a 'blue ocean' strategy. These try to offer affordable flights, whilst still being somewhat comfortable. Hence, they are a mix between low-cost and differentiated. A notable example of this approach is JetBlue.

To understand how the US airline industry developed into its current form we must look at its history. Between 1940 and 1978, the industry was highly regulated, as air travel had been deemed a public utility. This entailed that any changes to schedules, fares or roots needed to be approved by the Civil Aeronautics Board, an institution notoriously reluctant to do so. Thus, the barriers to entry were profoundly high, allowing incumbents to charge exorbitantly high-ticket prices. To combat this, the Airline Deregulation Law came into effect in 1978, allowing for increased competition. This in turn produced a pronounced drop in ticket prices and the establishment of more routes.

20 years of increased competition were then followed by consolidation via mergers, caused by the quest for profitability. Recent high-profile mergers include the $17.7bn deal between Delta and Northwest Airlines in 2008 and the 2013 $11bn merger of US Airways and American. In addition to increased deal-making, firms have also promoted other measures to become more profitable, such as creating alliances. Such cooperation aims at marketing flights and coordinating operations.

One example of such is the "Northeastern Alliance", organized in 2021 by JetBlue and American Airlines. The US justice department, however, sued to block this alliance. It had argued it was necessary to preserve competitive pressures, as well as signaling its stance towards further merger activity in the US airline industry.

Severity of Coronavirus Pandemic

Today, the industry is impacted by two main factors. The first is the effect the coronavirus pandemic has had on it. During the pandemic year of 2020, US airlines lost a combined $35bn. Even though the industry has now returned to profitability, posting a $2.7bn profit in Q3 2021, and passenger numbers are nearly back to pre-pandemic levels, the effect of the global disease will have a long-term impact on air travel.

One obvious effect is the high levels of debt firms needed to take up to survive the pandemic. In the US, airlines loaded up on nearly $20bn of debt since 2019, having already been heavily indebted before COVID-19. This implies they might struggle to 'take off' as restrictions on travel ease, as a high portion of their operating profits will need to be used to service and pay down debt.

Another factor that further dampens the outlook is the higher fuel prices. Famously, oil prices dropped to negative territories in the US during the eve of the pandemic, only to surge on the news of Russia's invasion of Ukraine. Even though further large increases in prices appear unlikely, coping with current levels of $100 per barrel is still prone to damage the industry. Worryingly, this appears to be a likely prospect today.

Sustained underinvestment in oil over the last decade, due to shareholders in oil majors demanding dividends rather than the development of new production capacities, as well as the destruction of the US shale oil industry, suggest that supply restrictions are here to stay for at least a few more years. It is hardly helpful that Russia's oil will be banned from much of the world market, due to the recent sanctions western governments have imposed upon it.

In addition, not all airlines are set to recover equally, as business travel is likely to never return to previous levels. Even though the decrease in the sector appears to be less stark than previously predicted, as those trying to win business, such as bankers or consultants, still profit from being in the same room as their potential clients, other business travel is unlikely to return. Company internal meetings, for example, are mostly held virtually now, as firms have realised that video conferencing also serves their purposes well.

Long Term Perspectives

Taking a more long-term view, the prospect of increased competition with other forms of transport, such as rail travel, is something to consider when looking at the industry. Currently, the US railway system is, overall, poorly connected. The trip from Boston to New York, for instance, requires 6 hours for 350km on an Amtrack train, compared with an hour-long flight.

Thus, flights are still a popular option. However, with the Biden administration's ambitious plans for infrastructure improvements and the overall desire to increase rail use, due to its more climate-friendly nature, we should expect the short-haul routes to become less demanded by customers. However, long-haul flights, such as coast-to-coast, don't have a viable alternative as of today, meaning these should continue to be a profit driver for airlines in the future.

In addition, as touched upon previously, climate change is another source of disruption for the industry. As it is heavily reliant on burning kerosene, it must switch to either electric or hydrogen-powered airplanes at some point, requiring a significant investment of capital. Thus, the future outlook of the airline industry appears riddled with difficulty. That said, will the industry face further consolidations? JetBlue, Spirit and Frontier would be in the affirmative.

Frontier-Spirit Deal

In early February this year, it has been reported that Frontier agreed to buy Spirit Airlines for $2.9bn in cash and stock, in a deal valued at a total of $6.6bn, including net debt. Shareholders have been offered a 19% premium on the stock's closing price on February 4th, through cash and shares in the new company.

The deal, if approved, was set to create the fifth-largest airline in the industry, at a combined 8.2% market share, with the mission of competing with the "Big Four" airlines, through an ultralow-cost strategy. This makes sense, as both companies are currently pursuing this strategy, and with a reported $500mn in synergies, and only $100mn from cutting costs, the deal seems to be allowing the merged company to offer even lower prices, thus truly threatening the establishment of the largest 4 US airlines.

However, since announcing that the deal will be completed in the latter half of 2022, some complications have arisen. The stance of antitrust authorities on the Airline Industry was made clear in 2021 when the US Justice Department blocked the "Northeastern Alliance". Furthermore, with Lina Khan, chair of the Federal Trade Commission and Jonathan Kanter, head of the antitrust division of the US Justice Department promising to take aggressive stances on any M&A activity in the industry, the deal looked far from done. Frontier executives were hoping that antitrust will focus more on the "Big Four", rather than companies that separately, have no chance of threatening that establishment, such as Frontier and Spirit.

JetBlue-Spirit Deal

While Frontier's bid was still being considered, in early April, JetBlue Airlines outbid Frontier, offering $3.6 billion ($33 a share), all cash, for Spirit Airlines, a 37% premium on the value implied by Frontier's offer.

However, their offer would allow Spirit shareholders to keep ownership of 48.5% of the new company. The deal would also surpass a Frontier-Spirit merger, being projected to take 8.6% of the market.

JetBlue executives have admitted that these 2 companies have different strategies, the main difference being that the acquiring firm places importance on more premium services such as business class and free wifi, and comfort on their aircraft, while Spirit strictly focuses on low prices. This raised questions on the motivation behind this offer, as a merger would mean upgrading 176 aircraft owned by Spirit, closing the gap between the 8.9 cents per available seat mile spent by JetBlue and 6.3 cents spent by Spirit and the pay gap between pilots, JetBlue's pilots being paid 12% more than Spirit's. All of these would come at huge costs.

Despite these, JetBlue executives have claimed that the new company could reach $700mn in net synergies in 3 years' time. Furthermore, the deal looks to bring JetBlue something invaluable: a presence on the West Coast. Currently, while having a notable presence on the East Coast, JetBlue has been struggling to expand on the other side of the country. A merger with Spirit would mean gaining access to key hubs such as Chicago, Dallas, and Atlanta. Lastly, both airlines operate Airbus A320 aircraft with the same engines, so despite the need to upgrade the interiors, training costs for Spirit pilots would be very low.

Spirit has agreed to entertain both offers, with board members admitting that the latter offer, by JetBlue, seems like the 'superior offer'. Frontier has attacked this offer, claiming that the high costs that JetBlue would face to upgrade Spirit's aircraft will result in higher ticket prices. Nevertheless, both deals make sense. A Frontier-Spirit merger seems more logical, as both companies have similar business plans and pursue virtually the same strategy. This clearly would favour consumers, through even lower ticket prices and access to a much larger variety of flights. Analysts doubt that the same outcome for the consumer would occur in the case of a JetBlue-Spirit merger. However, this latter offer seems to be the better at first glance, but Spirit shareholders might reject it on the basis of losing their entire ownership of the new company. A JetBlue-Spirit merger might still reduce prices while offering a degree of comfort that would enable price-sensitive consumers to afford comfortable travel. The clear benefit of this deal would be a notable presence on the West Coast, and therefore a much larger variety of flights offered to customers.

Antitrust Considerations

The outcome of this American airlines 'saga' is not only dependent on the 3 companies involved. It might seem that the ball is in Spirit's court, but in truth, the power is held by Antitrust Authorities. Regulators have taken an aggressive stance on mergers in the Airline Industry and elsewhere under the Biden Administration, meaning that neither of the 2 outcomes presented above might happen.

In terms of the likelihood of each of the 3 scenarios happening (Frontier deal is accepted, JetBlue deal is accepted or neither of the 2), the JetBlue-Spirit deal seems least likely. Regulators will have been left with a sour taste after JetBlue's attempt to form a "Northeastern Alliance" with American back in 2021. Moreover, the resulting company would take a higher market share than Frontier-Spirit would, meaning that it is more likely to threaten competition. Lastly, the question of whether ticket prices would rise has still not been answered, as it seems clear that a merger would bring massive costs to JetBlue, costs that need to be offset somehow. The Frontier- Spirit deal looks to be much more straightforward: 2 companies with similar strategies that would create the fifth-largest airline in the US in a bid to boost competition by lowering ticket prices seems plausible and harmless, in theory.

But judging by the stance of the US Justice Department on the Airline Industry in the US, they might just want to preserve the status quo. The reality is that the Airline Industry is a tough, competitive place as it is and non-existent M&A activity in recent years has pointed to the industry being established in the eyes of regulators, meaning that there is a high chance that neither of the 2 deals goes through.

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