

By: Michael Fabey

The buzz of spring is accompanied this year by the buzz of airline merger talk, and analysts say there's a simple reason: The timing is right.

From a stockholder standpoint, the airlines now enjoy the highest market value they have had for some time. Analysts say that means the time is right to talk again about mergers and acquisitions. Some possible combinations might look a lot better in 2010, now that airlines are not so preoccupied with spiking fuel prices and the recession.

"With the financial outlook better now, renewing talks seems reasonable," analyst Kevin Crissey of UBS said in an April 8 note to investors.

Analyst Vaughn Cordle of the consultancy AirlineForecasts agreed, adding that when oil prices start rising again and airlines face increased taxes and other additional costs in coming years, the airlines' value will be diminished, and mergers could become harder to sell to stockholders.

"Balance sheets have been sucked dry of tangible equity, and labor is biting at the bit to recoup ... cuts in total compensation," he said. "This is the time now to work out the best deal to create the best deal for shareholders."

That's especially true, he said, for the trio of airlines involved in the chatter: United, US Airways and Continental.

"All of these airlines are basket cases," Cordle said in an AirlineForecasts note on the merger rumors. "They continue to shrink [in market share] vis-a-vis the [low-cost carriers], and their only salvation will come from their ability to fully participate in a branded global alliance such as Star, SkyTeam or Oneworld."

He said that "historically, major U.S. network carriers developed their strengths in regions, but none were truly national."

The key to success today, however, is having a national network linked to a global alliance, Cordle added.

Too many airlines?

"The airline industry remains a financial mess, with no major U.S. airline earning its cost of capital," Crissey said. "Consolidation, though not easy, riskless or free, is a logical way to attempt to rectify this long-standing problem."



He added that, based on previous deals, a "major merger" could reduce industry capacity by 2% to 3%, mostly in domestic markets.

Not everyone agrees that consolidation is the way to go. Raphael Bejar, CEO of AirSavings, an airline consultancy that specializes in helping carriers make ancillary purchases, said, "Consolidation like this is not a solution. In this case, bigger is not better.

"If they want to become profitable, they have to change their business model. They have to become more like low-cost carriers."

But such a shift is unlikely, Bejar said. Should the merger rumors turn out to be true, he said, a more promising union would be United and Continental, combining the former's strength in the Pacific, for example, with the latter's strong presence in Latin America.

Crissey and Cordle agreed, with Cordle saying that a United-Continental merger would create almost twice the postmerger value of United-US Airways.

No executive from any of the three carriers has confirmed or denied any consolidation talks.

Although executives have mentioned the possibility of airline mergers over the past several months, especially with the seemingly successful merger of Delta and Northwest, rumors started flying in earnest at the beginning of the month about renewed talks for a United-US Airways union. The airlines were last reportedly in merger talks about two years ago.

Some analysts have suggested someone in United was behind the rumor, or leak, of talks with US Airways in order to draw Continental back into merger discussions.

"A United bid for US Airways would encourage Continental to reconsider a merger with United," Cordle said. Continental faces a big risk, he said, if United and US Airways were to merge.

"United wins with a US Airways merger, and it wins even more if Continental decides to work with United or even makes a bid for United to pre-empt a linkup between US Airways and United."

United and Continental last talked in May 2008, Crissey said, but negotiations were halted as the carriers focused on oil prices, which had risen to \$130 per barrel.

