Reaching New Heights Together: How Airlines Can Maximize the Value of Joint Ventures

The ground-breaking partnership between Northwest Airlines and KLM Royal Dutch Airlines more than two decades ago ushered in an era of increasing cooperation among global carriers. Once focused on modest collaboration such as selective codesharing and reciprocal frequent flyer benefits, joint venture agreements today have in many cases become so tight as to be virtual mergers. Emboldened by the spread of Open Skies agreements, which provide the foundation for airlines wishing to coordinate activities, a growing number of carriers are seeking the synergies of a merger even as they stop short of full unification. More than 15 airlines now participate in immunized joint ventures. L.E.K. research suggests that such arrangements were responsible for an astonishing 30% of all global long-haul traffic in 2013, up from only 9% a decade ago.

In some cases, immunized JVs occur between large, global airlines, such as the recent market-disrupting tie-ups between Qantas and Emirates, and Delta and Virgin Atlantic. In other cases, executives for flagship carriers pursue JVs with regional airlines to gain access to growth markets – a proposition that appeals to regional airlines because of the economies of scale offered by a global partner. Japanese carrier ANA’s recent purchase of an equity stake in Myanmar Airlines and Delta’s innovative partnership with GOL are examples of such symbiotic relationships between big and small carriers.

We believe that deeper integration between JV partners of all sizes is inevitable, and that “virtual mergers” will become increasingly popular around the world. L.E.K. market forecasts suggest that by 2023, 45% of all global long-haul traffic will be part of a JV. With transatlantic markets largely mature, this substantial growth is likely to come from increased collaboration between developed and developing markets. In the case of Latin America, L.E.K. projects that well over half of the traffic bound for North America will be linked to a joint business within 10 years. How these partnerships are structured and managed will determine their success. In this paper, we highlight the key questions for airline executives and investors looking to capture the maximum value from joint ventures.

Building a Strong Foundation

Airlines have long understood that trust is essential to their relationship with customers. Building trust between erstwhile competitors does not come as naturally. The longevity and success of JVs depends on airlines’ ability to construct equitable and flexible partnership arrangements. In most cases, these arrangements will be founded on the principle of “metal neutrality,” which dictates that revenue or profit is shared proportionally no matter which airline actually flies the passenger. Metal neutrality helps align incentives and build trust. But the preservation of standalone value – that is to say, pre-deal financial performance – is also key to establishing confidence from the onset.

Reaching New Heights Together: How Airlines Can Maximize the Value of Joint Ventures was written by John Thomas, a Managing Director in L.E.K. Consulting’s Boston office, and Brett Catlin, a Senior Consultant at L.E.K. Consulting. For more information, contact aviation@lek.com.
of negotiations. From this foundation, there are a host of potential considerations regarding the structure, mechanism and governance for both parties to analyze and negotiate.

Determining the Right Structure

Determining the structure of joint ventures lays the groundwork for all subsequent negotiations. L.E.K.’s experience suggests that the most successful agreements focus on several key questions:

- **Which regions or routes will the partnership agreement cover?** Will there be full metal neutrality for all of these routes? How will “behind” and “beyond” traffic be handled – that is, the connecting flights to and from the shared gateways?

- **How will exclusivity be addressed?** Will there be carveouts to preserve existing relationships? Will multiple parties be permitted to operate on the same city-pairs?

**Market Example:** When Delta Air Lines and Virgin Atlantic executed their JV agreement in late 2012, they elected to include all traffic between the United States, Canada and Mexico to London and to explicitly exclude substantial Virgin Atlantic leisure traffic destined for the Caribbean.

**Market Example:** When Air France, KLM and Delta formed a transatlantic JV, it included specific carveout provisions to capture and jointly account for connecting traffic from Los Angeles to Papeete and from Amsterdam to India. As a result, Delta and KLM split operations to India, with Delta exclusively operating to Mumbai and KLM exclusively operating to New Delhi. In contrast, the A++ JV between Air Canada, Lufthansa and United fully covers...
all traffic between North America and Europe, Africa, the Middle East and India.

- **Will service standards and selling practices be aligned across carriers?** Will fare buckets and pricing programs be integrated?

  **Market Example:** Following the close of a JV deal between ANA and Lufthansa, the two parties worked to simplify fare structures and to harmonize joint selling. The unification resulted in ANA being able to competitively sell tickets to 190 European destinations, up from 120 destinations prior to the agreement.

**Deciding on a Partnership Mechanism**

The most tenuous and time consuming portion of JV formation often involves determining how revenue or profit will be calculated and ultimately allocated. This is understandable: Negotiating an equitable mechanism to calculate and allocate the current and future performance of the joint business is critical given the permanence of the agreement. With that in mind, executives should ensure they thoroughly explore all options by examining the following questions:

- **Will the joint enterprise operate as a revenue-sharing or profit-sharing venture?**

  **Market Example:** While the vast majority of JVs are structured as revenue-sharing ventures, Delta has executed profit-sharing agreements for both of its transatlantic joint ventures. While challenging to negotiate and implement, Delta decided that profit sharing ultimately ensured an optimally aligned incentive structure.

- **How will standalone (i.e., baseline) profitability of each party be determined?** How many years prior to the agreement will be considered? Will adjustments be permitted to account for irregularities?

  **Market Example:** The transatlantic JV between American Airlines, British Airways and Iberia determined standalone profitability by using the 2008-2009 period as the baseline to the agreement, with a 15% allowance for codeshare traffic which transits behind or beyond the gateway airport.

- **Will there be a parity-payment adjustment (that is, a payment from a poorer-performing partner to a higher-performing partner to make that partner whole) to address differences in baseline profitability?** How will the financial mechanism to protect standalone performance be structured?

- **Which sources of revenue will be subject to the agreement (e.g., ancillaries, loyalty revenue, cargo, etc.)?**

**Figure 2**

Seats Falling Under JV Agreements, by Region (2003-23F)*

Note: *Includes routes at least 2,500 nm in length with at least 52 flights p.a.
Source: Diio Mi, L.E.K. analysis
**Figure 3**

**Historical Mechanisms of JV Agreements**

<table>
<thead>
<tr>
<th>Year</th>
<th>Partners</th>
<th>Current Mechanism</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>A++ (Air Canada, Lufthansa, United)</td>
<td>Revenue</td>
</tr>
<tr>
<td>2009-10</td>
<td>Delta, Air France, KLM, Alitalia</td>
<td>Profit</td>
</tr>
<tr>
<td>2010</td>
<td>American, British Airways, Iberia</td>
<td>Revenue</td>
</tr>
<tr>
<td>2011</td>
<td>ANA, United</td>
<td>Revenue</td>
</tr>
<tr>
<td>2011</td>
<td>American, JAL</td>
<td>Revenue</td>
</tr>
<tr>
<td>2011</td>
<td>Delta, Virgin Australia</td>
<td>Revenue</td>
</tr>
<tr>
<td>2012-13</td>
<td>ANA, Lufthansa, Austrian, Swiss</td>
<td>Revenue</td>
</tr>
<tr>
<td>2013</td>
<td>Qantas, Emirates</td>
<td>Revenue</td>
</tr>
<tr>
<td>2013</td>
<td>British Airways, Japan Airlines, Finnair</td>
<td>Revenue</td>
</tr>
<tr>
<td>2013</td>
<td>Delta, Virgin Atlantic</td>
<td>Profit</td>
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</tbody>
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Source: American, Delta, KLM, Lufthansa and Virgin Atlantic press releases; Examiner; Bloomberg; Financial Review; Business Traveller; L.E.K. analysis

- **For profit-sharing agreements, how will costs be allocated to the JV?** What is the mechanism to deal with unilateral escalation in labor costs – for example, if one airline is contractually obligated to increase pay for pilots and other flight staff at a certain date?

- **Again for profit-sharing agreements, how will the inclusion of certain assets, such as the introduction of new aircraft or the purchase of slots, be accounted for in the agreement?**

- **Will a proportionality clause be enforced to regulate capacity growth?** How will any imbalance be addressed? What is the mechanism to reduce shared capacity?

  Market Example: Over the past three years, while Air France, KLM and Delta have collectively withdrawn nearly 3% of seats from the transatlantic market, the carriers relative split has remained stable at 45% (DL) and 55% (AF/KL) – a strong indication that a proportionality cause has been enforced as joint capacity was rationalized.

**Ensuring Good Governance**

A good rule of thumb for establishing a strong governance structure is for executives to hope for the best, but plan for the worst; even the most amicable partnership can turn sour (and expensive!) in the face of unforeseen circumstances. Strong governance can be established by addressing the following representative questions:

- **What is the length of the agreement?** Will an ever-green provision or termination penalties be included?

  Market Example: When Air France/KLM and Delta inked an integrated agreement in May 2009, they favored a long-term, auto-renewing arrangement that can only be canceled with three-years’ notice after a period of 10 years.

- **Who owns pooled resources such as takeoff and landing slots at major airports and how are those resources managed by the JV?**
• Under what conditions, if any, will the partnership agreement be void (e.g., insolvency by one party)?

• How are approval and/or veto rights structured for major decisions? What is the protocol for resolving disputes?

• What is the process for terminating the partnership? If liquidated damages or other remedies will be required, how will they be calculated? How do you structure an agreement that permits minimal disruption should that agreement fall apart?

Looking Toward the Future

As the model matures, airlines may pursue further opportunities to monetize the assets of the JV to the benefit of shareholders. For instance, executives may choose to spin-off the JV portion of their business in an IPO – a bold strategic move similar to the loyalty program spinoffs undertaken by Air Canada, Aeromexico and others over the past decade. Such a structure would enable the asset to be independently valued, while providing investors with the ability to invest in a specific region or route system.

Whatever course they take, we expect immunized joint ventures will continue to gain favor across the airline industry. Our forecasts suggest that in 10 years nearly half of all long-haul traffic will be carried by an airline participating in a JV. How much value such partnerships bring to industry stakeholders will depend in large part on how the questions raised in this paper are addressed.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded 30 years ago, L.E.K. employs more than 1,000 professionals in 22 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.