



Reaching New Heights Together in 2017: How Airlines Can Maximize the Value of Joint Ventures

The groundbreaking 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 code sharing and reciprocal frequent flyer benefits, joint venture agreements today have in many cases become so tight as to be considered “virtual mergers.”

Emboldened by the spread of Open Skies agreements, which largely eliminate regulatory hurdles 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 20 airlines now participate in immunized joint ventures. L.E.K. Consulting research suggests that such arrangements were responsible for an astonishing 25% of all global long-haul traffic in 2016, up from only 5% 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, flagship carriers pursue JVs with regional airlines in order to gain access to growth markets, a proposition that appeals to regional airlines because of the economies of scale offered

by a global partner. Dutch carrier KLM’s long-standing equity investment in Kenya Airways and Delta’s innovative partnership with GOL are examples of such symbiotic relationships between big and small carriers.

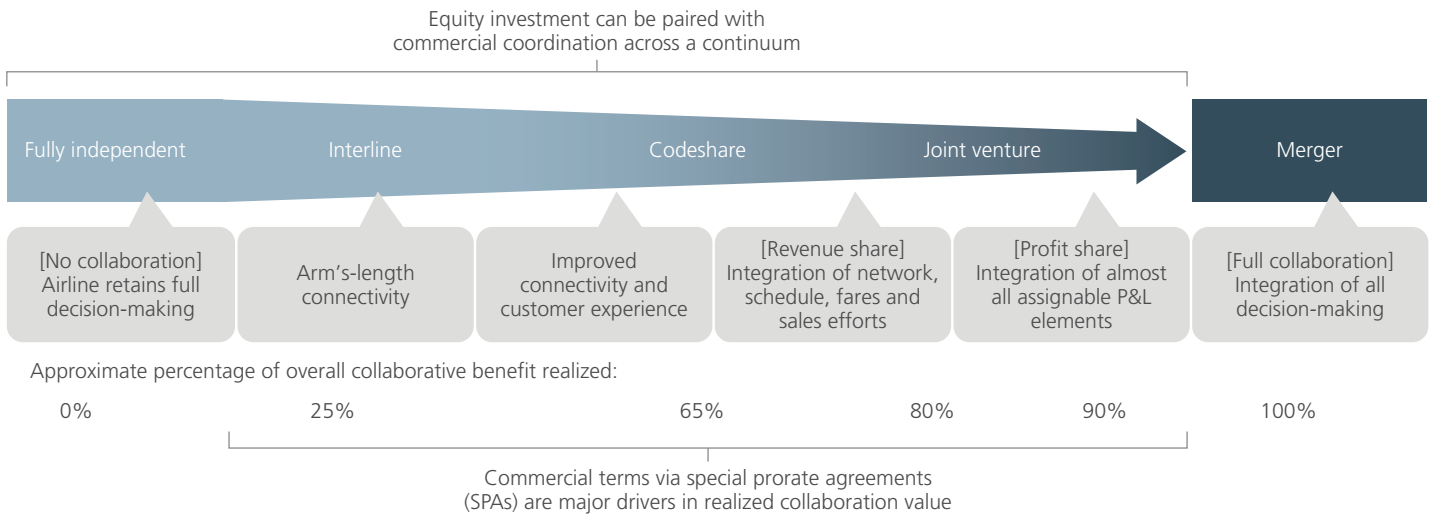
We believe that deeper integration between JV partners of all sizes is inevitable, and that virtual mergers will become increasingly popular around the world. We also believe that by 2021, 35% of all global long-haul traffic could be part of an immunized joint venture. With transatlantic markets largely 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 could be linked to a joint venture within five years.

Looking to Asia, strong demand growth to Europe and North America will continue to encourage airlines to form new joint ventures and to further extend existing partnerships. Chinese airlines could feature prominently in the future partnership landscape, given the explosive growth in traffic between China and the rest of the world as well as the growing importance of its major mainland airports. How these partnerships are structured and managed will determine their success. In this *Executive Insights*, we highlight the key questions for airline executives and investors looking to capture the maximum value from joint ventures.

Reaching New Heights Together: How Airlines Can Maximize the Value of Joint Ventures was written by **Alan Lewis**, **Zafar Momin** and **Peter Smith**, Partners, and **Brett Catlin**, a Senior Engagement Manager at L.E.K. Consulting. Alan and Brett are based in Boston, Peter is based in London and Zafar is based in Singapore.

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Figure 1
Airline partnership continuum



Source: L.E.K. analysis

Building a strong foundation

Airlines have long understood that trust is essential in their relationships with customers. Building trust between erstwhile competitors does not come as naturally. The longevity and success of JVs depends on airlines' abilities to construct equitable and flexible partnership arrangements. In most cases, these arrangements will be founded on the principle of "metal neutrality": revenue or profit is shared no matter which airline actually flies the passenger. Metal neutrality helps airlines 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 of negotiations. From this foundation, there are a host of potential considerations regarding structure, mechanism and governance for both parties to analyze and negotiate.

Determining the right structure

The structural elements behind joint ventures often form the basis for negotiations. Determining the structure of JVs lays the groundwork for all subsequent negotiations. Our experience suggests that the most successful agreements are based around the answers to the following key questions:

- Which regions or routes will the partnership agreement define as "home" or "trunk" markets? How will "behind" and "beyond" traffic — that is, the connecting flights to and from the agreed "home" markets — be handled?

For example, the joint venture between Singapore Airlines and Lufthansa Group covers the traditional Lufthansa Group "home" markets of Austria, Belgium, Germany and Switzerland while Singapore Airlines' "home" markets consist of a broader set of markets that includes Singapore, Malaysia, Indonesia and Australia. Similarly, when Delta Air Lines and Virgin Atlantic executed their JV agreement in late 2012, they elected to explicitly exclude substantial Virgin

Spotlight: Mainland China Partnerships

In many ways the Chinese market is the next frontier for airline partnerships. While the country's tripartite of major airline groups has long participated in global alliances, there has been only modest partnership activity beyond these multiparty schemes. As regulatory restrictions ease, there are new signs of increased cooperation on the horizon. At the forefront is the groundbreaking joint venture between Air China and Lufthansa Group, which is scheduled to commence during the summer of 2017. Major carriers from the United States are following Lufthansa's lead with recently announced equity investments by Delta Air Lines and American Airlines in China Eastern and China Southern, respectively. These initial equity tie-ups often lay the groundwork for subsequent joint ventures once the requisite regulatory frameworks (e.g., Open Skies) are in place.

Figure 2
Example joint venture agreements and benefit-sharing mechanisms

Year (most recent renewal)	Joint venture partners	Benefit-sharing mechanism
2009	A++ (Air Canada; Lufthansa; United)	Revenue
2009	Delta; Air France; KLM; Alitalia	Profit
2010	American; IAG; Finnair	Revenue
2011	ANA; United	Revenue
2011	JAL; American	Revenue
2011	Delta; Virgin Australia	Revenue
2011	Air New Zealand; Virgin Australia	Revenue
2012	ANA; Lufthansa; Austrian; Swiss	Revenue
2013	Qantas; Emirates	Revenue
2013	Japan Airlines; IAG; Finnair	Revenue
2013	Delta; Virgin Atlantic	Profit
2014	Air New Zealand; Singapore	Revenue
2014	Air France; KLM; Kenya Airways	Profit
2016	Singapore; Lufthansa	Revenue
2017	Delta; Aeromexico	Profit
Pending	LATAM; American	Revenue
Pending	LATAM; IAG	Revenue
Pending	Air New Zealand; United	Revenue
Pending	Air China; Lufthansa	Revenue
Pending	Delta; Korean Air	Profit
Pending	American; Qantas	Revenue

Source: L.E.K. research of legal filings, press releases and news reports

Atlantic leisure traffic destined for the Caribbean while including the rest of North America within the transatlantic agreement.

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

For example, when Air France, KLM and Delta formed a transatlantic JV, it included specific carve-out 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?

For example, following the formation of the JV between ANA and Lufthansa, the two parties worked to simplify fare structures and to establish “zones” within Europe and Japan in order to standardize fares based on transit point or operating airline. The unification resulted in ANA being able to competitively sell tickets to 190 European destinations, up from 120 destinations prior to the agreement.

- Will both passenger and cargo revenues be pooled in the JV agreement?

For example, the pending JV between LATAM and American Airlines includes passenger revenue as well as revenue from all cargo products and services in the revenue-sharing mechanism.

Deciding on a partnership mechanism

One of the most difficult and time-consuming elements of JV formation often involves determining how revenue or profit will be calculated and ultimately allocated. 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 a profit-sharing venture?

For 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. Although this approach is challenging to negotiate and implement, Delta decided that profit-sharing ultimately ensured an optimally aligned incentive structure. Delta's use of a profit-sharing mechanism has more recently extended to its newly consummated JV with Aeromexico and pending agreement with Korean Air.

- 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?

For example, the transatlantic JV between American Airlines, British Airways and Iberia determined standalone profitability by using the 2008-2009 period as the baseline of the agreement, with a 15% allowance for codeshare traffic that 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?

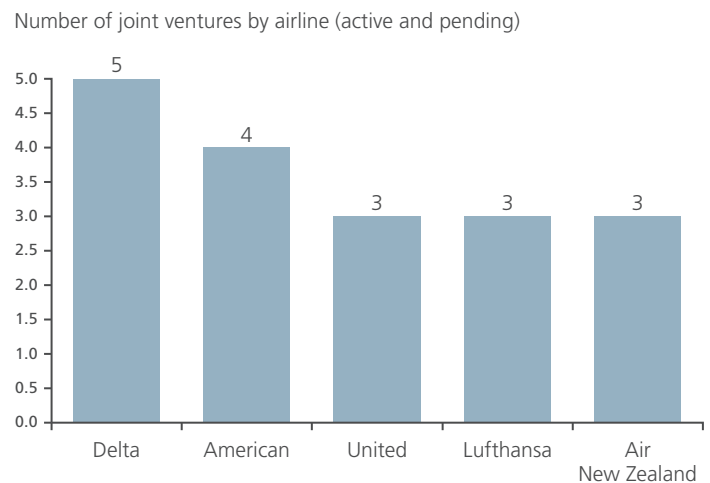
For example, market reports have recently highlighted the cash settlement from KLM to Kenya Airways as a result of degrading performance from the baseline position agreed to by the two carriers.

- Which sources of revenue will be subject to the agreement (e.g., ancillary revenue, loyalty revenue)?

For example, under the proposed JV between LATAM and American Airlines, revenue and expenses associated with mileage accrual and redemption will be included within the sharing mechanism. The parties explicitly called out the importance of credit card programs tied to frequent flyer programs when including this revenue.

Figure 3

Number of joint ventures by airline (active and pending)



Source: 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 if, for example, one airline is contractually obligated to increase pay for pilots and other flight staff by a certain date?
- Will a proportionality clause be enforced to regulate capacity growth? How will any imbalance be addressed? What is the mechanism to reduce shared capacity?

For example, from 2010 to 2013 Air France, KLM and Delta collectively withdrew nearly 3% of seats from the transatlantic market, while the carriers' relative split has remained stable at 45% (DL) and 55% (AF/KL) — a strong indication that a proportionality clause 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 questions:

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

Executive Insights

For example, when Air France/KLM and Delta/Northwest inked an integrated agreement in May 2009, they favored a long-term, auto-renewing arrangement that can be cancelled only with a three-year notice, and that can be given only after a period of 10 years from the date of the JV.

- Who owns pooled resources such as takeoff and landing slots at major airports, and how are these resources managed by the JV?

For example, Air New Zealand and Singapore Airlines included a separate “Slot Transfer Agreement” in their revenue-sharing joint venture that dictates the process for optimizing their joint slot portfolios at Singapore Changi Airport.

- Which components of the JV agreement, if any, will be eligible for renegotiation after the deal has been consummated?

For example, Kenya Airways renegotiated its JV agreement with KLM from a 40/60 split of incremental profits/losses to a 50/50 split.

- Under what conditions, if any (e.g., insolvency by one party), will the partnership agreement be void?
- How are approval and/or veto rights structured for major decisions? What is the protocol for resolving disputes?

For example, the transatlantic JV between Delta, Air France/KLM and Alitalia is structured with 11 working groups empowered with decision-making authority across the areas of network, revenue management, sales, product, frequent flyer, advertising/brand, cargo, operations, information technology, communications and finance.

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

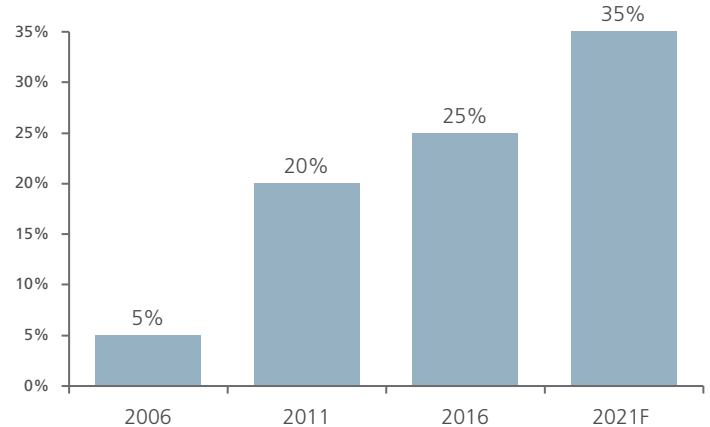
Looking toward the future

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 separate or spin off the JV portion of their business in an IPO, a bold strategic move similar to the loyalty program separations 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.

Figure 4

Joint venture share of total traffic for flights over 3,000 miles

Joint venture share of total traffic for flights over 3,000 miles (2006-2021F)
Percentage of seats



Source: L.E.K. analysis

Whatever course airlines take, we expect immunized joint ventures will continue to gain favor across the industry. Our forecasts suggest that in five years' time, over a third of all long-haul traffic will be carried by an airline participating in a JV. There is no question that partnership models will continue to evolve as airlines strategically and opportunistically evaluate combinations that best serve their business objectives. How much value such partnerships bring to industry stakeholders will depend in large part on how well these deals address the questions raised in this paper.

Editors note: While L.E.K. advised the parties cited in a number of the examples, all data are sourced from publicly available records, including antitrust legal filings, press releases and news articles.

About the Authors



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