Case Study: Exploring Strategic Alliances, Mergers & Acquisitions – examples from Air-France and KLM in De Wit and Meyer (2010:823-836)

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Executive Summary

The airline industry plays a critical role in the economic development of both developed and developing nations. However, the airline industry is a volatile due to a number of systematic risk factors like war, terrorism, advancements in telecommunication, and economic fluctuations that adversely affect passenger numbers. In the last decade, a number of airlines have been rendered bankruptcy due to declining passenger numbers. In order to survive this kind of environment, most airlines have resulted to forming strategic alliances, mergers and acquisitions in order to remain afloat and profitable. This study examines the strategic alliances that have been formed and particular the merger between Air France and Dutch airlines KLM. The study examines the benefits and challenges that accrued to the newly formed airline. In addition, the study examines how mergers, strategic alliances, and acquisitions are used to gain competitive advantage in the airline industry. The findings of the study reveal that the two airlines merged as a result of financial constraint. However, the merger has brought core competence and dynamic capabilities to Air France-KLM. This has in turn enabled the airline to gain competitive advantage over competing airlines. The study further notes that corporate social responsibility is an avenue that institutions can use in order to enhance the performance of an airline or any corporation for that matter.

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Introduction

The corporate environment is described as a dynamic environment. This can be attributed to a number of factors including the ever changing needs and tastes of consumers, and advancements in the field of technology. Corporations therefore have to develop measures that will enable them to remain profitable in the corporate environment; a case that applies to the airline industry. In this case, the report will Air-France-KLM was formed after the merger between of two European airlines namely French Air France and Dutch KLM. Air France was a national carrier of France and was majority owned by the French government, however the French government reduced its stake after the merger. Similarly, Dutch KLM was a Dutch airline, with immense national recognition. The merger was completed in 2004, resulting to the largest airline group in Europe. Both airlines, before the merger were respectable corporate brands in the airline industry, both nationally and internationally, and they coming together was expected to bolster their performance in the competitive airline industry. However some industry pundits saw the alliance as a bad move, something that led to the stock prices of both airlines dropping after the merger went public. According to Som (2009), the airline industry was characterised by alliances and thus mergers were viewed with scepticism. Industry experts did not view the merger of Air France and Dutch KLM as a strategy for the airlines to gain competitive advantage. This report, therefore analyzes the effects of strategic alliances, mergers and acquisitions within the airline industry. The study analyzes the benefits and limitations that accrue to airlines as a result of strategic alliances, mergers and acquisitions. It further focuses on the merger between Air France and KLM. The paper is divided into three questions each having two sub-sections. The study provides solutions to these questions with the aim of determining: whether the merger between

the two airlines resulted in competitive advantage for the two corporations and also why more institutions are embracing corporate social responsibility activities as a strategy.

Question One: Core Competence, Dynamic Capability and Competitive Advantage

Meanings and definitions

Dreger (2002) describes core competence as skills or resources that an institution has in its possession that has the following aspects: (1) gives the firm competitive advantage over other firms in the same industry; (2) extent to which its skills and resources can transcends to other firms; (3) challenge for competing firms to imitate the skills and abilities that are held by a particular firm. It further involves co-ordination, integration and collective learning. Hoskisson et al. (2008) define core competence as institutional resources that have the following characteristics: not easily substitutable, rare, valuable, and costly and hard to imitate. The core competence of an institution can be evaluated from two aspects: (1) consumers have the perception that an institution's capability to produce products and services that are none substitutable and also valuable; (2) competitors want to imitate the capabilities that the institution has (Hoskisson et al., 2008). Core competence, thus enables companies to differentiate their products and services through the use of unique skills and resources. Differentiation is a strategy used by companies to gain competitive advantage over their competitors in the same industry. This implies that core competencies give an institution or firm a competitive advantage over firms in the same industry.

Dynamic capabilities are described as the ability of an institution to: (1) sense and be conversant with the threats and opportunities that are within the market it operates within; (2) have the ability to pursue the opportunities that arise in the market; (3) employ sustainable a viable competitive strategies (Teece, 2009). Not every institution and corporation has dynamic

capabilities i.e. able to be adaptable to the ever changing needs of consumers. Dynamic capabilities also involve the ability of institutions and firms to adopt various viable business models that would enhance service delivery and product quality (Teece, 2009). Institutions which have dynamic capabilities have the ability to adapt to the surrounding corporate environment which is described as dynamic and ever changing. In addition, firms which have dynamic capabilities have the ability to satisfy the ever changing needs, tastes and preferences of consumers. Due to rapid technological changes, changing consumer patterns and behaviours, the corporate environment has become unpredictable and thus companies need to have dynamic capabilities to respond to the ever evolving business landscape, and thus gain competitive advantage.

Competitive advantage is described as a scenario whereby an institution consistently produces products and delivers services that continuously meet the needs and demands of the majority of the consumers in the market (Drejer, 2002). In addition, competitive advantage is achieved by the ability of a firm to integrate and combine the resources that it has in its disposal. Pfeffer (1994) also describes competitive advantage as a scenario whereby an institution has the following attributes: (1) a firm can easily be distinguished from competing firms by consumers or the market; (2) an institution which has the capabilities that cannot be easily reproduced or imitated by competing firms; (3) the institutional resources and capabilities enable the institution to achieve significant economic benefits. From the given set of definitions, it is evident that institutions which have core competencies and dynamic capabilities gain competitive advantage over competing firms which are in the same industry.

Air France-KLM Airline's core competencies and dynamic capabilities

Meersman, Voorde and Vanelslander (2008) argue that the airline industry is a capital intensive industry. This implies that corporations and individuals who seek to invest in the airline industry need a large amount of capital since aircraft acquisition is an expensive venture. In addition, the airline industry is characterised as a dynamic corporate environment (Meersman et al., 2008). The industry can is also described as highly volatile and prone to systematic and international risks (Emerald Insight, 2004). Economic recession, terrorists, wars and political instabilities, natural calamities, and advancement in technology have a direct impact on the performances of airlines throughout the world. For airlines to survive the unpredictable business environment they need core competencies and dynamic capabilities.

Before the merger both airlines were national champions in their respective countries. The coming together of the two airlines enhanced their image. The merger also enhanced core competencies of the two airlines, which resulted to widespread brand, increased planes, increased employee numbers, increased hubs, wider networks, bigger supplier for maintenance activities and enhanced management. In this case, the airline was able to strategically position itself to compete against major airlines where economies of scale are critical for increased margin. The merger of the two airlines resulted to a corporation with huge financial muscle, which is a dynamic capability to respond to changes in the airline business.

Due to these core competencies and dynamic capability of Air France-KLM, the airline company has withered the tough economic times to grow its financial base when many airlines are going under. The core competencies and dynamic capability have helped the airline leverage on its economies of scale, which arose after the merger. Economies of scale are the benefits that an institution has as a result of being big in terms of resources. The two airlines were among the

best airlines in their countries i.e. France and Netherlands. This implies that the merged company had a wealth of resources in terms of human skills on how to manage an international airline. The newly formed airline thus had competent staff who aided it in the development of strategic measures that would aid the firm gain competitive advantage over competing airlines. In addition, both airlines had immense financial resources that could acquire the necessary technology that could aid the firm incur low operational costs. There increased fleet resulted to efficient and effective cost management as revenues were maximized and operational costs minimized.

Question Two: Strategic Alliances and Mergers and Acquisitions

Strategic alliances and mergers and acquisitions in the airline industry

A strategic corporate alliance is described as a scenario whereby two or more institutions partner and associate with the aim of achieving certain objectives and aims (Glisson et al., 1996). It is important however to note that the corporations that form a strategic alliance remain distinct. Once the objectives of the strategic alliance are achieved, the parties to the partnership or association can agree to end the strategic alliance. Sherman (2011) defines mergers as a scenario whereby two or more institutions or organizations join to form one firm. In particular, for a merger to take place there must be an acquiring firm and another firm or organization which is being acquired. Sherman (2011) argues that the liabilities and the assets of the acquired firm are legally transferred to the acquiring firm. On the other hand, Sherman (2011) defines acquisitions as scenario whereby an institution entirely buys out another institution or organization. Evripidou (2012) carried out a research study which sought to examine the motivation that made various airlines merger. The findings of the study revealed that airline companies form strategic alliances and mergers because of the following factors: (1) benefit from economies of scale; (2)

attain efficiency in costs; (3) gain market power. The findings of this study revealed that when systematic risk is low, airlines can significantly benefit from mergers and acquisitions as a result of increased revenues. Brueckner and Pels (2005) conducted a research study that sought to determine the benefits that accrued Air France and KLM as a result of their merger in 2004. According to the findings of the study, Air France-KLM benefited from increased revenues and profits. This illustrates that strategic alliances and mergers and acquisitions are critical for the survival of airlines during tough business environment (Oum, Park and Zhang, 2000; Nair, Palacios and Ruiz, 2011; Nair, Palacios and Tafur, 2011). This can be confirmed with reference to how the financial markets reacted to their newly formed alliance. Moreover, Friesen (2005) argues that after the merging of the two airlines; the share value of KLM increased tremendously. This is the despite the fact that KLM had made a loss of $47million. However, the share value of Air France remained the same. These findings suggest that mergers and acquisitions can aid the value of a firm increase significantly. This is because; the airline had a huge goodwill from the passengers, investors and the market who hoped that the merger will have positive outcomes for both of the institutions. By so doing, the airline had a platform and resource capability to market their services.

Glisson et al. (1996) carried out a research study that sought to determine the effects of strategic alliances between airlines. The findings of their study revealed that airlines result to forming strategic alliances as a result of increased competition both in the domestic and international market. In addition, the increased regulation of the airline industry can result in the formation of strategic alliances of airlines. According to Glisson et al. (1996), the development of strategic alliances between airline companies results in: enhanced passenger or consumer welfare and

increased profit for the airlines. Consumer welfare is advanced in terms of enhanced services for instance between connection flights, and favourable passenger fares.

Rajasekar and Fouts (2009) conducted a study that sought to examine the benefits that accrue to domestic airlines from forming strategic alliances with international airlines. The findings of the study revealed that domestic airlines benefit from increased markets, increased passenger load factor and revenue passenger miles. This signifies that airline alliances result in airlines gaining competitive advantage over airlines which do not have any alliances.

Low cost leadership and product differentiation

According to Porter (1985) low cost leadership and product differentiation are strategies used by companies to gain competitive advantage in their industries. The airline industry is a competitive industry characterized by intense competition, fuel price volatility and low passenger numbers. An airline company that fails to strategize to gain competitive advantage over its industry peers certainly does not survive. For instance, Veldhuis (2005) argues that the merger between Air France and Dutch KLM was formed as a result of low returns and excess capacity. This implies that financial constraints on the part of the two airlines could have resulted in the two airlines merging. Similarly, Emerald Insight (2004) states that Airlines employ the following strategies in order to remain afloat: reduction of institutional and operational costs, and forming strategic alliances. In this respect, airline companies use a variety of strategies to gain competitive advantage. In the case of Air France-KLM, the airline used low cost leadership and product differentiation to withstand competition and tough economic operating environment. According to Som (2009) the merger between the two airlines created synergies that helped them to reduce fares in their unprofitable routes and a target of reducing fares by 10% annually. Low cost leadership is a strategy that involves selling of products and services at low prices to attract

customers (Peng, 2008; Flouris and Oswald, 2006). Economies of scale attributable to mergers and association helped Air France-KLM to offer reduced fares without running into loses. This strategy would have been unprofitable before the merger when both airlines were operating as distinct entities. Due to the robust financial resources and increased fleet, Air France-KLM was able innovate new products such as business traveller and frequent flyer programme as differentiation strategy. This two strategies, low cost leadership and product differentiation, helped Air France-KLM airline achieve competitive advantage in the airline industry.

Question Three: Corporate Social Responsibility

Organizational purpose and corporate profitability corporate responsibility paradox

Institutions operate within an environment which is made up of many stakeholders. Institutional stakeholders within the corporation environment can be divided into two: internal and external stakeholders. The internal stakeholders are made up of the individuals and institutions which are directly affected and concerned with the day to day running of an institution. In addition, persons who have stakes within an institution can be described as individuals who are within the internal stakeholders circle. Examples of internal institutional stakeholders include: employees, customers, shareholders, suppliers, creditors and the government. The external stakeholders are made up of stakeholders who are indirectly affected by the activities of a corporation. The members of the society within which the corporation or institution conducts its activities make up the external stakeholders of the corporate environment.

Institutional activities affect the environment within which they operate within and thus corporations need to participate in the development and preservation of that environment. This is because; most of the stakeholders within an institution live within the environment which the corporation operates within and are thus affected by the activities of that institution. When the

stakeholders both internal and external are negatively affected due to corporate activities, the institutional performance of the institution will also be at stake. Institutions and corporations therefore need to ensure that they are concerned with the environment in which they operate within. It is for this reason that most institutions engage in corporate social responsibilities activities. Corporate social responsibility (CSR) is whereby institutions are involved in the solving or providing solutions to the problems that the society faces (Werther & Chandler, 2006). However, most institutions confuse corporate philanthropy and CSR. CSR encompasses a scenario where the society approaches an institution or corporation for assistance in order that through partnership they provide a solution to a certain phenomena that plagues the society. On the contrary, corporate philanthropy is whereby a corporation make a donation from their revenue to solve a certain concern within the society. However, the members of the society are not consulted when it comes to corporate philanthropy unlike CSR where the members of the society are consulted before the activity is undertaken (Werther & Chandler, 2006).

It is necessary for institutions to satisfy the needs of all its institutional stakeholders i.e. both internal and external. By so doing, the corporation’s long term success is most likely guaranteed. However, satisfying the needs of various institutional stakeholders and neglecting the needs of others will most likely be successful in the short run but will not be sustainable in the long run. In addition, consumers are in recent times considering the ethical behaviour and CSR activities of companies in their buying behaviour (Werther & Chandler, 2006). Empirical evidence suggests that consumers prefer to purchase products or receive services from institutions that do CSR as compared to those which do not. This implies that CSR can aid in the building of a brand identity of an institution that is ethical and which cares for the members of the society who live around where it operates. By so doing, customer loyalty will increase and also market share will

most likely increase. Thus, the firm's revenue and profits will increase considerably (Chen & Wang, 2011).

Corporate profitability and corporate social responsibility

Corporate social responsibility (CSR) plays a critical part within institutional set ups. It assists an institution in a number of ways. First, CSR enables an institution to build its brand as an ethical company whose purpose is also to ensure social welfare. Secondly, through various associations through CSR activities; an institution is able to communicate with various institutional stakeholders and can hence become more innovative and be in better place to serve the market. Thirdly, the firm can gain tax incentives from the government with reference to the philanthropic activities of the firm. Empirical literature suggests that there is a positive correlation between corporate performance and CSR activities. This implies that when a corporation increases its engagement in CSR activities; it will have a positive impact on institutional performance (Chen & Wang, 2011; Saleh, Zulkifli & Muhamad, 2011).

Airlines have for a long time been criticized for their impact to the environment. It is for this reason that Air France-KLM has undertaken a CSR activity that will see it reduce its emission to the environment (Air France-KLM, 2006). The airline has invested a substantial proportion of their resources in research in development of engines and fuel that will aid in the reduction of emissions. This venture can be regarded as a CSR activity because there has been increased activism from the international community for firms to be environmental conscious. According to Air France-KLM (2006), this CSR activity has resulted in the airline reducing its carbon emissions through the utilization of bio fuels. In addition, the airline is the perception that by offering its services - i.e. transport – it is in a position to advance social welfare and further facilitate economic development to all its destinations. Through its CSR activities, Air France-

KLM has increased its profitability. It has done so by being embraced by the world as one of the airlines that has invested hugely in the research and development of aircrafts and fuel that is friendly to the environment. This implies that the activists or individuals who are environmental friendly will prefer to use the airline over other airlines which have not embraced environmental friendly technology.

Conclusion

The airline industry can be described as a volatile industry. This is because; it is affected by a number of factors like war, terrorism, economic performance, advancement in technology and communication, and competition. Several international airlines have become bankrupt and have been liquidated because of declining passenger numbers. As a result, airlines have to develop strategies that will aid them remain afloat and profitable despite the poor performance that has characterized the airline industry in recent times. Empirical evidence suggests that one of the factors that resulted in the merger between KLM and Air France is because of financial instability. However, the merger has had positive effects on the new airline: enhanced financial performance and lower operational costs. The findings suggest that the new airline has competitive advantage over competing airline because of economies of scale. For instance, the benefit for being big is that the airline has had the ability to acquire the latest technology that enables it enhance the quality of services it offers while at the same time lowering its institutional costs. In addition, the acquired technologies have made their aircrafts more environmental friendly and thus aided the firm achieve its corporate social responsibility goal.

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