

Background

On February 13, 2013 the New York Times announced that US Airways and American Airlines agreed to a merger that would create the largest airline in the United States.¹ The following day, the satirical publication, The Onion, made a similar announcement that "American Airlines, US Airways Merge to Form the World's Largest Inconvenience."² This, of course, emphasizes the almost unanimous feeling that flying, and travel in general, has deteriorated in quality dramatically in the past couple of decades.

In a transaction valued at approximately \$11 billion dollars and had received both companies board's approval, it was unclear as to whether or not the value was appropriate, even considering that American had been in bankruptcy since 2011 and had suffered losses greater than \$12 billion since 2001. The proposed structure would give US Airways shareholders with a 28 percent stake in the new airline, while American Airlines shareholders, creditors, employees, and unions with an equity stake of 72 percent.³

So, given the state of where American Airlines was operating and the subsequent financial losses, was it valued appropriately and did the courts serve in the best interest of the American Airline creditors and shareholders? Conversely, if the price was too high without any attainable synergies, than the transaction would not be equitable for US Airways shareholders as well. It is clear that American needed a partner to emerge from bankruptcy, but certainly unclear as to the risks under such a transaction could take on US Airways.

¹ Mouawad, Jad. And Ed. Sorkin, Andrew Ross. "American and US Airways Announce Deal for \$11 Billion Merger" The New York Times February 13, 2013

² <http://theonion.com/articles/american-airlines-us-airways-merge-to-form-worlds.31302/> Accessed April 8, 2013

³ Mouawad, Jad. And Ed. Sorkin, Andrew Ross. "American and US Airways Announce Deal for \$11 Billion Merger" The New York Times February 13, 2013

The Merger of American Airlines and US Airways

**John D Sullivan, PhD
Boston University**

©2013 John D Sullivan, PhD, Boston University All Rights Reserved. This case is intended as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. No part of this publication may be copied, stored, transmitted, reproduced or distributed in any form or medium whatsoever without the permission of the copyright owner. This case was compiled from published sources. publication may be copied, stored, transmitted, reproduced or distributed in any form or medium whatsoever without the permission of the copyright owner. This case was compiled from published sources.

But despite years of prosperity and profitability after the age of United States deregulation, American lost steam after 2008 and eventually sought bankruptcy protection on November 29, 2011 under Chapter 11 of the United States Bankruptcy Code in the United States Bankruptcy Court for the Southern District of New York (Case No. 11-15463-SHL). American is presently operating with "debtor in possession" financing to continue the survival of the business. While the filing of bankruptcy has triggered an automatic default on substantially of its debt obligations with protections for the company's assets during this period, the company will continue to operate as though nothing had happened. The bankruptcy code protects existing assets and also provides the company to operate its subsequent business with the court granting additional relief with regards to employees, taxing authorities, insurance providers, independent contractors, foreign vendors, joint venture partners, and other vendors that are felt to be important to the Debtor's operations.⁶

American's financial performance during the past few years had been far less than stellar. In 2012, the company lost \$1.9 billion on revenue of \$24.8 billion. In 2011, American lost \$2 billion on total revenues of \$24 billion and in 2010 lost \$469 million on revenues of \$22.2 billion. 2010 was a better year than 2009 when American generated revenues of \$19.9 billion and only a loss of \$1.5 billion.⁷

US Airways

While US Airways can trace its routes back to the original airlines that emerged after 1939, the company as it exists today is a combination of several mergers and acquisitions following the industry's deregulation under the Reagan administration. Based in Tempe, Arizona, US Airways Group operates its wholly owned subsidiaries US Airways, Piedmont Airlines, Inc., PSA Airlines, Inc., Material Services Company, Inc. (MSC), and Airways Assurance Limited (AAL). According to the 2012 Annual Report or SEC form 10K, "MSC and AAL operate in support of our airline subsidiaries in areas such as the procurement of aviation fuel and insurance."⁸

The present company, US Airways Group, was formed in Delaware in 1982. But despite economies of scale through mergers with other competitors, US Airways also spent time in bankruptcy, unheard of prior to the age of deregulation. Upon the company's emergence from bankruptcy protection on September 27, 2005, US

⁶ Ibid, p. 5

⁷ American Airlines. Securities and Exchange Annual Report Form 10K Filed February 13, 2013 p. 36

⁸ US Airways Group, Inc. Securities and Exchange Annual Report Form. 10K Fiscal Year End December 2012. p. 5

American Airlines

Founded in 1934, American Airlines and its subsequent subsidiaries grew to provide destinations throughout North America, the Caribbean, Latin America, Europe, and Asia. The company, including its subsidiaries, on average flew 3400 daily flights to 250 cities in 50 countries with a combined network fleet of 900 aircraft. As part of the *oneworld* airline network, the combined resources serve more than 800 destinations in approximately 150 countries and nearly 900 daily flights.⁴ In addition to passengers, American also is one of the largest freight and mail carriers in the world.

The domestic airline industry is extremely competitive. As a result, most United States carriers operate a hub and spoke system to maximize route and aircraft utilization and revenue through operations management systems that leverage fixed assets keeping planes as full as possible. American uses five primary hubs for its business model: Dallas/Fort Worth, Chicago O'Hare, Miami, New York City, and Los Angeles. Outside of its primary target markets, American utilizes American Eagle to bring passengers and cargo to smaller or fewer served markets. Competing airlines offer similar services.

Depending on the domestic route, American faces competition from either one or several airlines. American presently competes within the United States with: Alaska Airlines, Delta Airlines, Frontier Airlines, Hawaiian Airlines, Jet Blue Airways, Southwest Airlines, Spirit Airlines, United Airlines, US Airways, Virgin America Airlines as well as some smaller regional carriers.

On an international basis, flights to destinations outside the United States accounted for approximately 40 percent of the airline's total revenue in 2012, 2011, and 2010. Here, the company competes with both private, public, but also state owned airlines. American, at this point, flies to the Caribbean, Canada, Latin America, Europe, and Asia. As a result, the company has formed international relationships and partnerships with: Air Berlin, Air Pacific, Air Tahiti Nui, Alaska Airlines, British Airways, Cape Air, Cathay Pacific, Dragonair, EL AL, Etihad Airways, EVA Air, Finnair, Gulf Air, Hainan Airlines, Hawaiian Airlines, Iberia, Japan Airlines, Jet Airways, JetStai Airways, LAN, Malaysia Airlines, Niki Airlines, Qantas Airways, Qatar Airways, Royal Jordanian, S7 Airlines, and West Jet.⁵

After the airlines were deregulated in the 1980s, carriers were permitted to establish their own domestic fares, rates, and charges, but the Department of Transportation maintained authority over certain international rates etc.

⁴ American Airlines. Securities and Exchange Annual Report Form 10K Filed February 13, 2013 p. 5

⁵ Ibid, p. 6

agreement also prohibited the company from pursuing other attractive strategic arrangements with airlines other than American while the transaction was still ongoing. Costs associated with the transaction would also be accrued regardless of whether or not the two companies merged. These would include legal, accounting, financial advising, and other administrative expenses that were common with a deal of this size. Lastly, management would need to keep its focus on moving ahead with transaction and may overlook opportunities in the market as a result.

The Transaction

Management believed that the combination of the two global carriers would create an airline that was better equipped to compete in a larger consolidated industry with significant global competition. To enhance shareholder value, management also believed that the combination of the two airlines created significant synergies, a benefit of shareholder support, and financial strength and flexibility while maintaining all existing hubs and services to all current destinations.

For the consumer, the management team claimed to increase choices and better service with a greater global network and the ability to connect customers to more places. To further benefit the customer experience, the company would provide additional investments in products and services, improve loyalty benefits through the expansion of opportunities to earn and redeem miles, and maintain a competitive product line for corporate accounts.

For employees, a new union agreement would be formed with the pilots and flight attendants to determine representation and single agreement protocols. Management also believed that this new partnership provided employees with a path to improved compensation, benefits, and career opportunities over the long term. American's pilot, flight attendant, and ground employee unions and US Airways' pilot union had agreed to terms for their collective bargaining agreements to be effective upon the merger close. US Airways flight attendant union had reached a tentative agreement which would include support for the merger.

The new ownership structure for the company would give existing AMR shareholders a 72% stake and US Airway shareholders the remaining 28%. The deal would be an all stock transaction with a combined 2012 revenue of \$38.7 billion. With headquarters in Dallas-Fort Worth, the company would also maintain a significant corporate and operational presence in Phoenix.

One time transition related expenses of \$1.2 billion would be spread out over the next three years through 2015 and include the integration of the information technology platform, the standardization of aircraft interiors, airports, and clubs. The cost also includes any management severance, relocation, and professional fees

Airways Group merged with America West Holdings Corporation with US Airways Group as the surviving corporation.⁹

US Airways presently operates as the fifth largest airline in the United States as measured by revenue per domestic passenger miles and available seat miles. As with American Airlines, US Airways operates under a hub and spoke system with major hubs in Charlotte, Philadelphia, and Phoenix with another major focus in Washington D.C.'s Ronald Reagan Washington National Airport. Through this network, the airline offers approximately 3,000 flights each day to about 198 destinations in the United States, Canada, Mexico, Europe, the Middle East, the Caribbean, and Central and South America. The company provides seasonal and scheduled service to 130 airports and through the airline's US Airways Express carriers served 157 airports with overlap of approximately 78 airports.

US Airways has been profitable for the past three years reporting operating income of \$856 million on total revenues of \$13.8 billion in 2012, operating income of \$426 million on revenues of \$13.1 billion in 2011, and operating income of \$781 on revenues of \$11.9 billion in 2010, respectfully.¹ (Exhibit 3)

At the conclusion of 2011, US Airways ended the company's slot transaction with Delta Airlines. By doing so, the airline shifted its focus back onto its present hub and spoke system. US Airways also operates a shuttle service between Boston, New York LaGuardia, and Washington National.

As of December 2012, US Airways operated approximately 340 mainline aircraft. US Airways Express operated 238 smaller regional jets and 44 turboprops.

As with American Airlines, US Airways also believed the industry was currently and would continue to be highly competitive. Price competition depended on each market with varying discount and promotion strategies to stimulate travel during lower volume times during the year. Perhaps slightly different than American, US Airways operated a significant number of flights in the eastern United States with shorter duration trips than most other airlines. Due to this system, the company believed that it could be more susceptible to other competition such as trains and automobiles if there were any major significant economic downturn or a change in customer discretionary spending.

In addition to the standard risks associated with the airline industry, US Airways also believed that a failure to complete the merger could adversely impact their business. Under the initial agreements, if the deal was not consummated, US Airways may be required to pay a termination fee of \$55 million or as much as \$195 million under certain circumstances outlined in the Merger Agreement. This

⁹ Ibid, p. 5

¹⁰ US Airways Group, Inc. Securities and Exchange Annual Report Form. 10K Fiscal Year End December 2012. p. 79

Questions for Thought

On the Financial Front

Did the \$11 billion dollar price tag represent an accurate value for American Airlines?

How does one value a company with continuous losses if value is determined by positive cash flow?

Is this merely a situation whereby the shareholders have no real choice given the amount of debt that's on American's balance sheet?

If the synergies did not materialize as expected, how would this impact the future of the new company? In other words, at what point does the lack of performance have a catastrophic impact on the new company's ability to survive?

Why would US Airways pay \$11 billion for a distressed company that needs fixing? Wouldn't they be better off from a financial risk perspective to let it fail and pick up what it can for free?

Is US Airways concerned that another player would step in and steal the transaction?

If you found something in due diligence that you felt might be "a material adverse affect" on the valuation, how would you re-value the transaction based on the subsequent "penalties" associated with the merger agreement?

Given US Airways Group and US Airways' credit ratings from the largest United States agencies, are concerned about their current debt load?

The Legal Perspective

Given the size of the transaction, US Airways must file a Hart Scott Rodino with the Federal Trade Commission. Does this filing guarantee approval by the Federal Government?

Do you believe that the combination of these two airlines violates anti-trust law? Why or why not?

incurred with the transaction. Synergies over the same time period were to be forecasted at \$1.05 billion primarily driven by Network Revenue and Cost synergies. Management also believed that compared with prior airline mergers, these projected synergies were conservative based on a percentage of Pro Forma Revenue projections.

Leadership over the company would remain similar with Doug Parker of US Airways taking the CEO role and Tom Horton of American acting as Chairman. The new board would be comprised of 5 American creditor representatives, 3 current American directors, and 4 US Airways representatives.

The new combined fleet of aircraft would include 801 narrowbody jets, 147 widebody jets, and a regional fleet of 563.

Although significant progress had been made towards completing the transaction, several hurdles still remained:¹¹

Stakeholder Approval Plan of Reorganization and approval by the U.S. Bankruptcy Court for the Southern District of New York

Customary closing conditions and regulatory approvals by the Federal Trade Commission: Hart Scott Rodino Filing

Approval by the US Airways shareholders

Assuming all these hurdles could be met, the target close was expected in the third quarter of 2013.

Conclusion

The new company, retaining the name American Airlines, would start the integration planning as management worked through the remaining hurdles throughout the Spring of 2013. However, there were questions that should be considered. First, was the valuation for American Airlines accurate? Did this transaction benefit the shareholders of US Airways? With the size of the new company and the dwindling number of international airlines operating around the globe, would this transaction impede trade or was it really creating an airline with the size and economies of scale to thrive in this highly competitive marketplace? From a financial perspective, what risks still exist for US Airways and its shareholders? What are the real benefits for US Airways and how do they really overcome their obstacles?

¹¹ American Airlines US Airways presentation. "Creating a Premier Global Partner" February 14, 2013

Exhibit 1

US Airways Group, Inc.

Assets	(in millions)	
	2012	2011
Assets		
Current Assets		
Cash	\$2,276	\$1,947
Investments	\$100	\$0
Accounts Rec.	\$298	\$327
Materials & Supplies	\$300	\$235
Prepaid Expenses	<u>\$608</u>	<u>\$540</u>
Total Current Assets	\$3,582	\$3,049
Property & Equipment		
Flight Equipment	\$5,188	\$4,591
Ground Property	\$1,005	\$907
Less Depr. \Amort	<u>(\$1,733)</u>	<u>(\$1,501)</u>
	\$4,460	\$3,997
Equipment Deposits	\$244	\$153
Total Property & Equip	\$4,704	\$4,150
Other Assets		
Other Intangibles, net	\$539	\$543
Restricted Cash	\$336	\$365
Other Assets	<u>\$235</u>	<u>\$228</u>
Total Other Assets	\$1,110	\$1,136
Total Assets	\$9,396	\$8,335

Given the fierce competition that still exists in the global airline industry, do you see any potential ticket/cargo pricing issues either domestically or international if this transaction is approved? How should the United States government or the European Union test and monitor this issue?

Does it matter that one of the two airlines is in bankruptcy? If American cannot emerge from bankruptcy on its own and would likely not survive as an independent company, should this impact the decision of the government given the number of employees working at American?

Given the scale of this transaction and the borders it crosses, should other countries have the ability to weigh in on this company's transaction? If so, should they also be financially accountable by a pro-rated rate?

Would you interpret a government approval as an indirect "bailout" of American Airlines?

From an economic perspective, if you do believe it is a form of a "bailout," does it differ from the government aid of General Motors aside from the obvious cash infusion of GM?

A pure capitalist would argue that the company should be liquidated. What are the drawbacks to such an action?

What are the social responsibilities of US Airways and American Airlines? While they need customers, do they owe anything to the community? Should they?

Exhibit 3

US Airways Group, Inc.
Consolidated Statements of Operations (in millions)

	2012	2011
Operating Revenue		
Passenger	\$8,979	\$8,501
Express Passenger	\$3,326	\$3,061
Cargo	\$155	\$170
Other	<u>\$1,371</u>	<u>\$1,323</u>
Total Revenue	\$13,831	\$13,055
Operating Expenses		
Aircraft Fuel	\$3,489	\$3,400
Salaries	\$2,488	\$2,272
Express Expenses	\$3,162	\$3,127
Aircraft Rent	\$643	\$646
Aircraft Maint	\$672	\$679
Other Rent\ Landing Fees	\$556	\$555
Selling Expenses	\$466	\$454
Special Items, Net	\$34	\$24
Deprec.\ Amort	\$245	\$237
Other	<u>\$1,220</u>	<u>\$1,235</u>
Total Operating Expenses	<u>\$12,975</u>	<u>\$12,629</u>
Operating Income	\$856	\$426
Nonoperating Income		
Interest Income	\$2	\$4
Interest Expense, net	(\$343)	(\$327)
Other, net	\$122	(\$13)
Total Nonoperating Inc.	<u>(\$219)</u>	<u>(\$336)</u>
Earnings Before Tax	\$637	\$90

Exhibit 2

US Airways Group, Inc.

Liabilities & Equity	(in millions)	
	2012	2011
Liabilities		
Current Liabilities		
Current Maturities	\$417	\$436
Accounts Payable	\$366	\$386
Air Traffic Liability	\$1,054	\$910
Accrued Comp	\$258	\$176
Accrued Taxes	\$181	\$163
Other Accrued Exp.	<u>\$1,027</u>	<u>\$1,089</u>
Total Current Liabilities	\$3,303	\$3,160
Non Current Liabilities		
Long Term Debt\Cap Leases	\$4,376	\$4,130
Deferred gains\credits	\$290	\$307
Post Retirement Benefits	\$172	\$160
Employee Benefits\Other	<u>\$465</u>	<u>\$428</u>
Total noncurrent Liabilities	\$5,303	\$5,025
Total Liabilities	\$8,606	\$8,185
Shareholder Equity		
Common Stock	\$2	\$2
Paid in Capital	\$2,134	\$2,122
Other Income\Loss	(\$7)	\$2
Accumulated Deficit	<u>(\$1,339)</u>	<u>(\$1,976)</u>
Total Equity	\$790	\$150
Liabilities & Equity	\$9,396	\$8,335

Exhibit 5

AMERICAN AIRLINES, INC.
 DEBTORS AND DEBTORS IN POSSESSION
 CONSOLIDATED BALANCE SHEETS
 (in millions, except shares and par value)

	December 31,	
	2012	2011
Assets		
Current Assets		
Cash	\$474	\$280
Short-term investments	3,408	3,714
Restricted cash and short-term investments	850	738
Receivables, net	1,105	883
Inventories, net	550	583
Fuel derivative contracts	65	97
Other current assets	<u>559</u>	<u>401</u>
Total current assets	7,011	6,696
Equipment and Property		
Flight equipment, at cost	17,687	17,890
Less accumulated depreciation	<u>7,502</u>	<u>6,981</u>
	10,185	10,909
Purchase deposits for flight equipment	710	746
Other equipment and property, at cost	4,993	5,012
Less accumulated depreciation	<u>2,912</u>	<u>2,904</u>
	<u>2,081</u>	<u>2,108</u>
	12,976	13,763
Equipment and Property Under Capital Leases		
Flight equipment	287	641
Other equipment and property	<u>200</u>	<u>199</u>
	487	840
Less accumulated amortization	<u>205</u>	<u>448</u>
	282	392
Other Assets		
International slots and route authorities	708	708
Domestic slots, net	161	183
Other assets	<u>2,126</u>	<u>1,847</u>
	<u>2,995</u>	<u>2,738</u>
Total Assets	<u>\$23,264</u>	<u>\$23,589</u>

Exhibit 4

US Airways Credit Ratings as of December 2012

	S&P	Fitch	Moody's
US Airways Group	B-	B-	B3
US Airways	B-	B-	*

*This credit agency does not rate this category for US Airways
Source: 2012 Annual Report 10K, p. 71

Exhibit 7

AMERICAN AIRLINES, INC.
DEBTORS AND DEBTORS IN POSSESSION
CONSOLIDATED STATEMENTS OF OPERATIONS
(In millions)

	Year Ended December 31,	
	2012	2011
Revenues		
Passenger - American Airlines	\$18,743	\$17,947
- Regional Affiliates	2,914	2,724
Cargo	669	703
Other revenues	<u>2,499</u>	<u>2,583</u>
Total operating revenues	<u>24,825</u>	<u>23,957</u>
Expenses		
Aircraft fuel	8,717	7,434
Wages, salaries and benefits	6,242	6,385
Regional payments to AMR Eagle	1,142	2,418
Other rentals and landing fees	1,286	1,305
Maintenance, materials and repairs	1,133	1,020
Commissions, booking fees and credit card expense	1,050	1,062
Depreciation and amortization	999	950
Aircraft rentals	550	673
Food service	535	518
Special charges	386	725
Other operating expenses	<u>2,744</u>	<u>2,637</u>
Total operating expenses	<u>24,784</u>	<u>25,127</u>
Operating Income (Loss)	41.00	(1,170)
Other Income (Expense)		
Interest income	(25)	25
Interest expense	(662)	(689)
Interest capitalized	50	40
Related party	(13)	(14)
Miscellaneous - net	<u>243</u>	<u>(41)</u>
	<u>(357)</u>	<u>(679)</u>
Income (Loss)	(316)	(1,849)
Reorganization Items, Net	(2,179)	(116)
Income (Loss) Before Income Taxes	(2,495)	(1,965)
Income tax (benefit)	<u>(569)</u>	<u>—</u>
Net Earnings (Loss)	<u>\$ (1,926)</u>	<u>\$ (1,965)</u>

Exhibit 6

AMERICAN AIRLINES, INC.
 DEBTORS AND DEBTORS IN POSSESSION
 CONSOLIDATED BALANCE SHEETS
 (in millions, except shares and par value)

	December 31,	
	2012	2011
Liabilities and Stockholders' Equity (Deficit)		
Current Liabilities		
Accounts payable	\$1,212	\$981
Accrued salaries and wages	631	489
Accrued liabilities	1,379	1,306
Air traffic liability	4,524	4,223
Payable to affiliates	2,753	2,644
Current maturities of long-term debt	1,388	1,518
Current obligations under capital leases	<u>31</u>	<u>—</u>
Total current liabilities	11,918	11,161
Long-Term Debt, net	6,762	6,729
Obligations Under Capital Leases, net	381	—
Other Liabilities and Credits		
Deferred gains	223	110
Pension and postretirement benefits	6,780	9,204
Other liabilities and deferred credits	<u>1,468</u>	<u>1,470</u>
	8,471	10,784
Liabilities Subject to Compromise	5,694	3,952
Stockholder's Equity (Deficit)		
Common stock - \$1 par value, net	—	—
Additional paid-in capital	4,469	4,455
Accumulated other comprehensive loss	(3,088)	(4,075)
Accumulated deficit	<u>(11,343)</u>	<u>(9,417)</u>
	<u>(9,962)</u>	<u>(9,037)</u>
Total Liabilities and Stockholder's Equity (Deficit)	<u>\$23,264</u>	<u>\$23,589</u>