An Analysis of Stockholder Returns and Synergistic Gains in Air France and KLM Royal Dutch Airlines Merger

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I. Background

Air France offered a fixed-exchange of stock offer to KLM Royal Dutch Airlines on 30th September, 2003; the exchange ratio of the deal is: 11 Air France shares for 10 KLM common shares and 10 Air France warrants with strike price €20 and maturity 3.5 years (Subscription parity: 3 warrants give the right to subscribe or to acquire 2 Air France shares). The terms of the deal has an implied value of KLM share as €16.74 and Air France would newly issue 51.5 million shares. The deal is friendly and expected to close in less than eight months.

The Air France and KLM deal created the largest airline in Europe, displacing British Airways to the second rank. KLM made several attempts to merge in previous years with other airlines, but was unsuccessful. It discussed a merger with British Airways in 1990, and explored a link-up, code-named "Alcazar" after a four-towered Spanish fortress, with Swissair, Austrian Airlines, and Scandinavian Airlines System in 1993. Yet, the talks failed because of the nationality problem: If KLM was acquired, it risked losing the right to fly abroad from Amsterdam—a restriction that the Open Skies Treaties did not amend. In 1997, KLM had a prominent partnership with Alitalia, when the two airlines were code-sharing and planning joint schedules. But, in 2000 the actual merger never materialized and the partnership failed due to delayed plans to create a new Milan airport hub, a key aspect of the airlines' plan.

The European Union recently abandoned the nationality rules among its members, implying that any European Union carrier could acquire another and fly freely with the twenty-five country bloc. United States government officials, however, indicated that it will not invoke the nationality rules, since both France and Netherlands had liberal Open Skies treaties with the United States. And, in key Asian and African markets, KLM risked losing landing rights if it did not remain a Dutch airline.

With the aim of protecting the traffic rights, the former Air France and the former KLM Royal Dutch Airlines would merge to create a new entity called Air France-KLM, which would be a

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listed company, and the two companies would operate as two independent companies. The target company, KLM will have 49% of voting rights, split as 36.3% of voting rights to the Foundation and 14.7% to the Dutch State. Additionally, the Dutch State has an option allowing itself to obtain 50.1% of KLM's voting rights if its traffic rights are challenged as a consequence of the nationality of KLM's shareholders.

II. Purpose of the Study

The purpose of the analysis is to apply theoretical and empirical techniques to the recent merger between Air France and KLM Royal Dutch airlines. Specifically, it is to compute the expected synergistic gains that are implied by the stock-market reaction to the announcement of the deal and then compare the same to the management's estimated synergies. On the announcement day, the management at Air France explicitly detailed the estimated synergies from the merger deal.

Furthermore, the analysis investigates closely the correlation of daily excess stock returns of Air France to KLM to prior to and after the announcement of the deal.

III. Empirical Analysis

In order to the study the merger, the daily stock price and trading volume for Air France and KLM were obtained from Bloomberg and Center for Research in Security Prices (CRSP) database respectively, for the period 1st August 2001 to 10th June 2004; and the daily stock returns for each company was computed. I also obtained the value-weighted CRSP market portfolio and the Bloomberg World Airlines Index for the same period and computed their daily returns.

The market model parameter estimates for both KLM and Air France are obtained using records from 1st august 2001 to 15th august 2003, using a maximum of 468 trading days of daily returns, which is at least a month before leakage of the merger news in *Wall Street Journal.*

Table 1: Market Model[a] Regression Coefficients for Air France and KLM Royal Dutch Airlines in the merger (estimated over period 1st August 2001 – 15th August 2003)

Firm	ά$_j$	β`$_j$	θ`$_j$	R^2
	(t-statistics in parantheses)			
Air France	0.00	1.30	0.97	0.29
	{0.80}	(11.83}	{10.27}	
KLM Royal Dutch	(0.00)	1.54	0.96	0.38
	{-0.14}	{15.52}	{11.25}	

[a] The two-factor Market Model is $R_{it} = ά_i + β_i`R_{mt} + θ_i`(R_{at} – R_{mt}) + ε_{it}$

Where,

R_{it} is the common stock return of firm *i* on day *t*; $R_{mt,}$ is the return to value-weighted CRSP market portfolio on day *t*, $ά_i$, $β_i`$, and $θ_i`$ are estimated regression coefficients; and $(R_{at} – R_{mt})$ is the airline index return after deducting return to value-weighted CRSP market portfolio on day *t*.

Using the regression coefficients thus obtained through the two-factor Market Model, I predicted the daily returns for both the airlines companies. I then computed the daily excess returns, which is actual daily returns less predicted daily returns for both the companies. My estimate of the gains created by the merger is based on market model prediction errors. Using, the two-factor market model approach, the abnormal return (prediction error) to firm *i* on day *t* can be written as

$$AR_{it} = R_{it} – ά_i – β_i`R_{mt} – θ_i`(R_{at} – R_{mt}),$$

Where

AR_{it} = abnormal return to firm *i* on day *t*,

R_{it} = realized return to firm i on day t,

$ά_i$, $β_i`$, $θ_i`$ = market model parameter estimates,

R_{mt}, = return to value-weighted CRSP market portfolio on day t, and

$(R_{at} – R_{mt})$ = airline index return after deducting return to value-weighted CRSP market portfolio on day t.

The daily t-statistics is computed as daily excess return divided by the standard error of the regression.

IV. Daily Average Trading Volume Analysis

To examine the effects of the merger announcement on the daily trading volume of Air France and KLM Royal Dutch, I first estimated the daily average trading volume of the two companies for the period 15th August 2002 to 15th August 2003 (this time window of one year ends at least one month pre-announcement in order to exclude effects of any leakage of the merger news). The daily average volume for Air France in this time period is 433.26 million and the same for KLM Royal Dutch is 57.25 million. I then computed the ratio of observed daily trading volume one-month prior to announcement (1st August' 2003) to the de-listing date (10th June, 2004) for KLM shares on New York Stock Exchange) and report this statistic. I observe that the daily trading volume in Air France and KLM's shares increases to at least 9.1 and 9.5 times the average trading volume respectively.

Figure 1: The ratio of daily trading volume, observed in the period one month pre-announcement,1st August 2003, till the de-listing date 10th June 2004 of KLM's common shares, to the estmated average volume for Air France and KLM

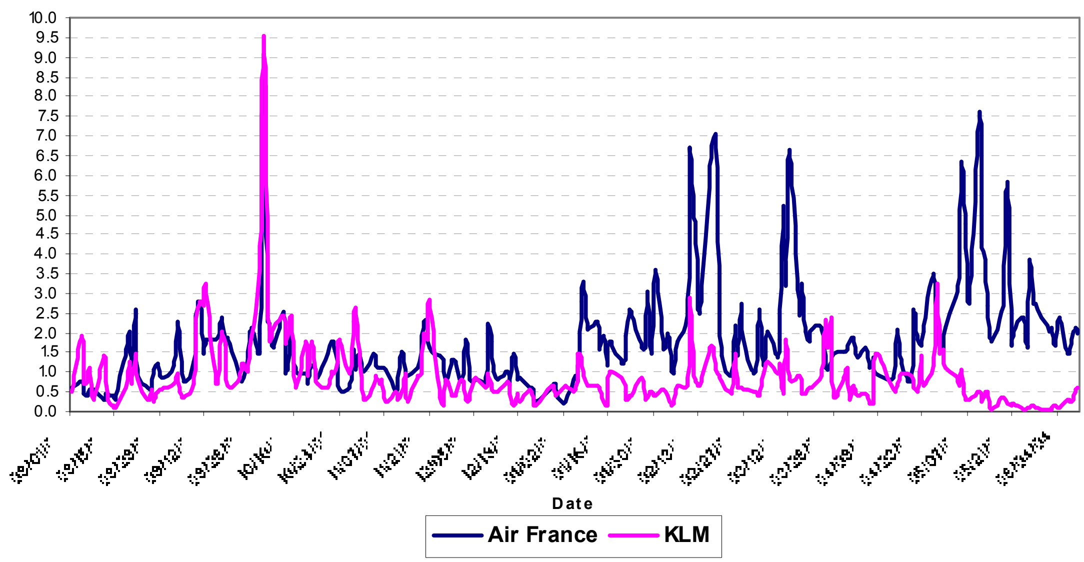


Table 2 below, shows the excess returns, t-statistics, and the ratio of daily trading volume to average daily trading volume for several key dates relating to the acquisition of KLM by Air France. KLM has significant excess returns (at the 5% significance level) for the day of the announcement of the merger deal, the day before the announcement, and when Air France announces better than expected financial results in February '2004. Table 2 also shows that trading volume for Air France and KLM was more than nine times average daily volume on the announcement of the merger deal. I use these excess returns and volume to do additional analyses as described below.

Table 2: Major events in Air France and KLM Royal Dutch Airlines merger and corresponding abnormal returns, t-statistics, and the ratio of daily trading volume to daily average trading volume.

		Air France			**KLM Royal Dutch Airlines**		
Date	**Article description**	**Abnormal Return**	**T-statistics**	**Ratio of Trading Volume**	**Abnormal Return**	**T-statistics**	**Ratio of Trading Volume**
09/16/03	Talks of potential tie-up between KLM Royal Dutch Airlines and Air France. Analysts speculate that KLM's inclusion into SkyTeam,is the likeliest outcome of the talks because of regulatory obstacles to a full merger	3.22%	1.03	1.97	-0.80%	(0.28)	1.24
09/17/03	Air France's board meets to approve a linkup with KLM Royal Dutch Airlines. Speculations: to avoid the regulatory hurdles a merger would face, Air France and KLM will create a jointly owned holding company, of which each airline would be a subsidiary.	-1.83%	(0.58)	2.38	-5.64%	(1.99)	2.03
09/29/03	The Air France board is expected to meet after its management briefs employees on the tentative alliance plans.	0.00%	(0.00)	1.55	8.07%	2.85	3.59
09/30/03	Both companies' officials hold official press release to announce that they expect to conclude an agreement. The main financial terms are announced. Air France files Form 425 and Form 14d-2.	-3.60%	(1.15)	9.10	9.83%	3.48	9.57
10/01/03	More press releases detailing Air France plans and explicit details of synergistic gains.	-3.89%	(1.24)	2.44	-7.64%	(2.70)	3.42
02/11/04	Air France and KLM receive the European Commission's clearance of their projected merger.	0.84%	0.27	5.05	2.52%	0.89	1.08
02/17/04	Air France announces third quarter results for fiscal year 2003-04.	3.37%	1.07	6.60	5.45%	1.93	1.70
05/05/04	Air France: Bid for Royal Dutch Airlines At Nearly $1 Billion Succeeds	0.38%	0.12	6.35	3.23%	1.14	1.07
05/12/04	Air France: Combined Traffic With KLM Increased by 20% in April	-4.92%	(1.57)	3.84	-2.64%	(0.93)	0.44
06/10/04	KLM Royal Dutch Airlines' shares are de-listed on NYSE	-0.05%	(0.02)	1.98	-8.64%	(3.06)	0.59

V. Event Study Announcement Effects

The observed daily stock price of KLM Royal Dutch Airlines exhibits excess returns that are significantly different from zero at 5% significance level on days t_{n-1}, t_n, and t_{n+1}, where , t_n is the day of the announcement of the deal. I also observe that the daily trading volume for both Air France and KLM is very high. Applying a four-day time window (t_{n-1}, t_n, t_{n+1}, and t_{n+2}, where, t_n is the day of the announcement of the deal) for both Air France and KLM, I computed the cumulative abnormal return (CAR).

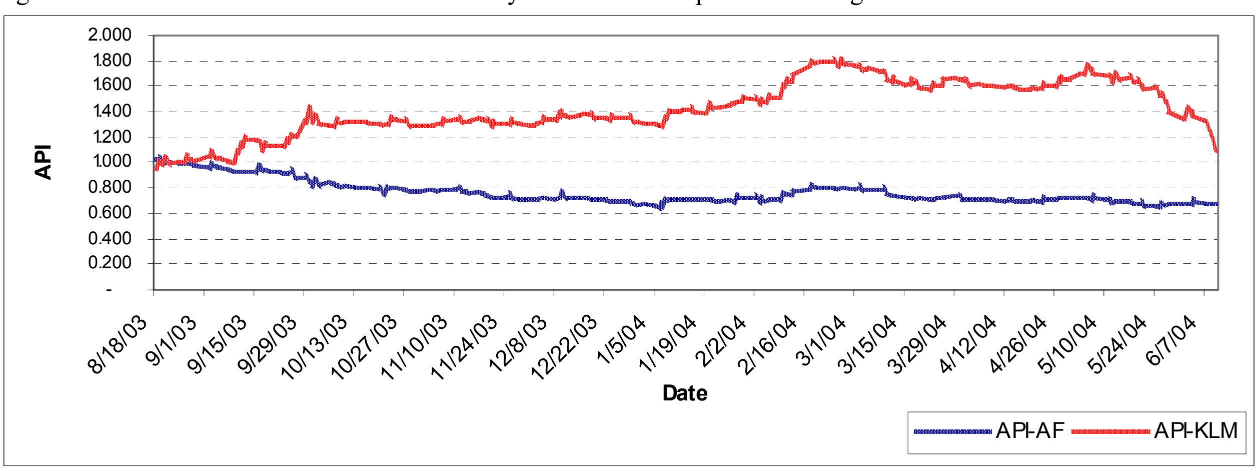
Table 3: Four-day cumulative abnormal return (CAR) for time window (t_{n-1}, t_n, t_{n+1}, and t_{n+2}, where , t_n is the day of the announcement of the deal) for both Air France and KLM.

Firm	**CAR** (t-statistics in parantheses)
Air France	-4.64% {-0.74}
KLM Royal Dutch	11.85% {2.09}

Furthermore, <u>for the entire merger-related period,</u> 18th September' 2003 to 21st May' 2004, the cumulative abnormal return for Air France was -33.25% (t-statistics -0.76) and for KLM, the cumulative abnormal return was 58.085% (t-statistics 1.48).

The abnormal performance index observed in the stock price for Air France and KLM Royal Dutch Airlines is plotted below. I observe that, as predicted, the stock price of the target company rises very high on the day of the announcement whereas the stock price of the acquirer goes down. I also find there is leakage of merger news before the announcement date by noticing that the target's stock price was already on a rise before the announcement date.

Figure 2: API Index of Air France and KLM Royal Dutch for the period 18th August 2003 to 10th June'2004



VI. The Implied Expected Synergies

We further extend my study of the estimated four-day cumulative abnormal return (CAR), to the increase in the market capitalization of both the airlines companies. Using, this four-day variable window CAR, I estimate the dollar gain to KLM and Air France as

$\Delta W`_{Ti} = W_{Ti} * CAR_{Ti}$, $\Delta W`_{Ai} = W_{Ai} * CAR_{Ai}$,

$\Pi = \Delta W`_{Ti} + \Delta W`_{Ai}$

Where

W_{Ti} = market value of KLM as of two days prior to merger announcement, t_{n-2},

CAR_{Ti} = cumulative abnormal return to KLM from one day before the first announcement date through two days after the announcement date.

W_{Ai} = market value of Air France as of two days prior to first announcement date, t_{n-2},

CAR_{Ai} = cumulative abnormal return to Air France from one day before the first announcement date through two days after the announcement date.

Π = market estimate of expected synergistic benefits to shareholders of the merging companies.

Table 4: The market estimate of the expected synergistic benefits to shareholders of Air France and KLM Royal Dutch Airlines.

KLM Royal Dutch		**Air France**	
$\Delta W`_{Ti}$	$72,547,958	$\Delta W`_{Ai}$	-$130,902,339
W_{Ti}	$612,274,800	W_{Ai}	$2,822,061,450
CAR_{Ti}	11.85%	CAR_{Ai}	-4.64%
t-statistics	2.095	t-statistics	(0.74)
Π = **-$58,354,381**			

The implied probability of the completion of the merger deal:

By observing KLM's stock price reaction, it appears that the probability (P) of the completion of the merger deal between Air France and KLM is 68.31%.

The estimate of probability was obtained as followed:

$$\text{Probability of completion of merger (P)} = \frac{P_{Actual} - P_{Fail}}{P_{Deal\ value} - P_{Fail}}$$

Where

P_{Actual} = Daily stock price of KLM on the day of announcement of the merger,

P_{Fail} = Daily average stock price of KLM observed two days prior to announcement and I conclude that there is leakage of merger news one day prior to announcement.

$P_{Deal\ value}$ = Implied value of KLM's stock price in Air France merger offer.

With my estimate of the probability of the completion of the merger deal, I thus compute the implied synergies if the deal closes, which is,

Implied synergies = Π / (P)

Where

Π = market estimate of expected synergistic benefits to shareholders of the merging companies as computed,

Table 5: The implied probability of and the implied synergistic gains from the completion of merger deal between Air France and KLM Royal Dutch Airlines.

P_{Actual} =	15.58
P_{Fail} =	13.08
$P_{Deal\ value}$ =	16.74
Probability (P) =	68.31%
π =	-58,354,381
Implied synergy =	-85,430,814

VII. Estimate of Synergistic Gains Announced by the Management

At the day of the announcement, the management at Air France communicated their estimate of the expected synergies.

Figure 3: Estimate of synergies as communicated in filing under Rule 425 under The Securities Act of 1933, and as under Rule 14d-2 of the Securities Exchange Act of 1934

I used the management's estimate of expected synergistic gains from the merger deal and computed the present value of net-of-tax total expected synergistic gains using discounted cash flow analysis and observed that, the management believes the present value net-of-tax expected synergistic gains, ten-year forward, would be €965.46 million. The amount is estimated as followed:

Table 6: Discounted Cash Flow Analysis of the management's estimate of expected synergies from the merger deal

Year	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Management's estimate	65.00	110.00	220.00	295.00	385.00	440.00	440.00	440.00	440.00	440.00
After tax	39.00	66.00	132.00	177.00	231.00	264.00	264.00	264.00	264.00	264.00
WACC (11.99%) [a]	0.89	0.80	0.71	0.64	0.57	0.51	0.45	0.40	0.36	0.32
Present value (PV)	34.82	52.62	93.98	112.53	131.13	133.82	119.49	106.70	95.28	85.08
Sum of Present value (ΣPV)	€ 965.46									
Number of target shares	48.90									
PV of Synergies per target share	€ 19.74									

[a] The median, weighted average cost of capital WACC based on the capital asset pricing model with a size premium is 11.99% — Ibbotson Associates, Cost of Capital 2004 Year Book, SIC Code 4512 Air Transportation, Schedule.

As computed, the estimate of the present value of expected synergistic gain per target share is €19.74 which exceeds €16.74 (the implied value of KLM's share from terms of the merger deal) by €3.00 per target share.

I, further estimate that the control premium per KLM's share offered by Air France is approximately equal to the implied value of target share *less* share price of the target two days prior to merger announcement, which is €16.74 *less* €13.08, or €3.66.

Thus, the implied net benefit to Air France per share is €3.60 as computed below,

$$\frac{\text{(PV of Synergy per KLM's share less control premium) * (Number of KLM shares outstanding)}}{\text{Number of Air France shares outstanding}}$$

Table 7: The implied net benefit to Air France per share

PV of Synergies per KLM's shares	19.74
Control Premium per KLM's shares	3.66
Number of KLM shares outstanding	48.90
Number of Air France shares outstanding	218.15
Implied Net Benefit per Air France share	**3.60**

I, thus conclude that the stock-market and management's estimate of net synergistic gains are very different. On one hand, the market estimates negative synergies and on the other hand, the management believes that the merger deal will have a net implied benefit of €3.60 per Air France share, which approximately equals €785.33 million in total.

I tried to investigate the difference between the two expectations of synergistic gains from the merger deal. The management's basis for such high expectation of synergistic gains is stated by them on the day of the announcement, and is as followed:

- Highly complementary long-haul networks—total of 101 long-haul destinations.
- Coordination of sales structures and sales cost improvements would save €100 million Ebit of annual synergies in five years.
- Network/scheduling optimization, revenue management harmonization, and optimization of fleet utilization would save €130-195 million Ebit of annual synergies in five years.
- Cargo and Network optimization and commercial alignments would save €35 million Ebit of annual synergies in five years
- Maintenance and Procurement pooling would save €60-65 million Ebit of annual synergies in five years
- Progressive convergence of IT systems would save €50-70 million Ebit of annual synergies in five years
- Procurement synergies would save €10-30 million Ebit of annual synergies in five years

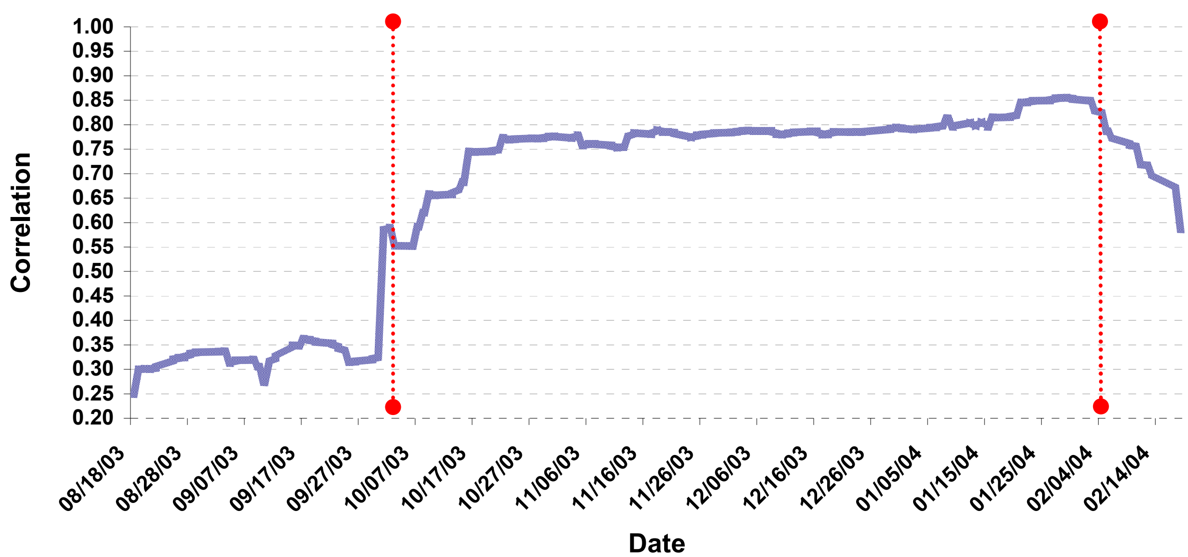
Therefore, the management believes that synergistic gains from the merger deal would amount to €385-495 million in earnings before interest and tax (Ebit).

I investigated whether the management anticipated some portion of the synergistic benefits in the form of reduced airfares, perhaps due to regulatory requirement. Yet, there was no indication in the management's news on the day of the announcement that made me believe that the prices would be reduced. Further, it is clear that the management has announced explicitly the terms of the synergies from the merger deal; still, the market gives them no credit. The market thinks there are not many success stories of airlines merger in the past history. Therefore, it thinks that the merger between Air France and KLM Royal Dutch Airlines would be hardly successful and reap almost no gains from the synergies.

VIII. Correlation Analysis

Since the terms of the Air France and KLM merger is a fixed exchange ratio of stock swap, KLM's stock price should move closely with that of Air France after the announcement of the deal, to the extent that the probability of the completion of deal is hundred percent. I know that the higher the probability of the completion of the deal, the greater would be the correlation between the two airlines' stock price. However, earlier in my study I mentioned that I estimate the probability of the deal closing to be 68.31% to begin with. Thus, I examined an eighty-day rolling correlation of Gross Returns from one month pre-announcement date of the merger (18th August'2003) to the date when KLM's shares were de-listed on New York Stock Exchange (10th June'2004). The estimates were plotted as below.

Figure 4: Rolling correlation of gross returns of KLM's stock to Air France's stock from 18th August 2003 to 10th June'2004.



In the above graph, I observe that the correlation jumps from an average of 0.33 (five days before the announcement date) to 0.57 (five days after the announcement date). On the 29th of January' 2004, the time the deal awaits the European Commission and United States Justice Department's approval, the correlation is the highest 0.86. The correlation between the two stock prices never reaches a perfect correlation of 1.00. However, to much of a surprise the correlation begins to decline: the correlation falls to 0.59, as of 18th February'

2004. I investigated this unusual pattern by looking for any evidence in the news, but did not find any justification for such a behavior.

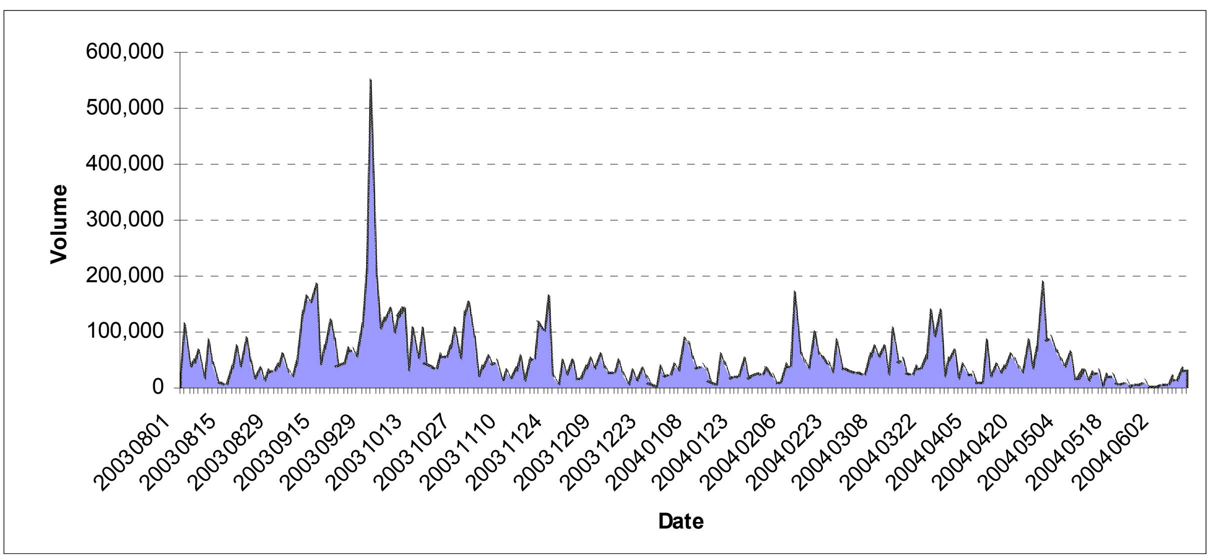
Another unusual pattern that was visible is that on the last four days before 10th June' 2004 when KLM's shares were de-listed on New York Stock Exchange, the stock price of KLM fell from the peak of €20.86 at around the deal completion date (5th May'2004) to €12.56 on the last day of trading (10th June'2004). The cumulative abnormal return (CAR) for KLM over these four days before the last trading date is -29.01% with a significant t-statistics of -5.22. The cumulative abnormal return (CAR) for Air France over the same period is 1.00% with an insignificant t-statistics of 0.16.

Table8: Cumulative Abnormal Return (CAR) as observed from 4th June'2004 to 10th June' 2004

	Air France	KLM Royal Dutch
CAR	1.00%	-29.01%
t-statistics	0.16	(5.13)

I could not find any explanation for the above-mentioned unusual pattern. At the expiry of the subsequent offering period on May 21st '2004, 96.33% of all KLM common shares were tendered. Therefore, I at best, speculate the reason for such a behavior is that the shares that were not tendered did not receive as good an offer that the tendered shares received. Moreover, the daily trading volume of KLM's shares declined since the completion of the offer; this pattern can be attributed to the fact that most shares were tendered. And, no such behavior in the daily trading volume of Air France shares was observed.

Figure 5: Daily trading volume in KLM's shares from 1st August '2003 to 10th June '2004



IX. Conclusion

My study of the Air France and KLM Royal Dutch Airlines merger has yielded several results, and raised several questions. I find that around the announcement date of the merger deal, on 30th September' 2003, the following impact was observed: using a four-day time window (from one day before the announcement date to two days post) the cumulative abnormal return (CAR) for Air France was -4.64% (t-statistics -0.74) and for KLM, the cumulative abnormal return was 11.85% (t-statistics 2.09). And, for the entire period 18th September' 2003 to 21st May' 2004, the cumulative abnormal return for Air France was -33.25% (t-statistics -0.76) and for KLM, the cumulative abnormal return was 58.085% (t-statistics 1.48).

Additionally, I estimated that the market expects the probability of the completion of the deal to be 68.31%. Using the cumulative abnormal return observed in the four-day window (from one day before the announcement date to two days post), the market believes there are negative synergistic gains of -€58.35 million from the merger deal. This deduction, is further reinforced by the fact, that the cumulative abnormal return in the merger-related period, thirty days before the announcement date till the last offer date 21st May' 2004, the cumulative abnormal return for Air France was -33.25% and for KLM, the cumulative abnormal return was 58.085%; and these would have rendered the same conclusion of negative synergistic gains. I investigated the expected synergies by the management, and by using discounted cash flow analysis, estimated the net-of-tax present value of synergistic gains to be €965.46 million. This estimate is very large and positive in comparison to the market's estimate and, if true, should have caused the Air France stock price to increase by €3.60 per share post-announcement of the deal, but it did not. There is a major discrepancy here and I attribute this to the history of mergers in airlines industry that have constantly failed to deliver synergies that were initially promised by the management.

I administered a rolling correlation between the stock returns of Air France and KLM Royal Dutch Airlines using an eighty-day window, and observed that the correlation increased from an average of 32.30% prior to the announcement date of the merger deal to an average of 70% in one month post-announcement date, and to 85% three months prior to completion of the deal. However; an unanswered question remains, that is: why does the correlation drops to 0.59 in the weeks before KLM's de-listing date of 10th June' 2004? I also observed that the cumulative abnormal return (CAR) of KLM in the last four trading days before the de-listing date of 10th June '2004 is -29.01%. I probed further and learned that 96.33% of all KLM common shares were tendered and thus I speculate that the remaining 3.67% shares, that were not tendered, must not have received as much compensation as the 96.33% must have; but, I found no public information to confirm this speculation.

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