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Strategies for Eastern European Airlines: The case of Malév Hungarian Airline

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Abstract

Threatened by financial crises and fierce competition, Eastern European flag carriers are forced to look for strategies to survive. While air transport liberalization has opened the European market for new airline operations in the nineties, it has also led to increasing competition in the market.

In the long run, consolidation seems to be the only successful strategy. Merging airlines claim substantial benefits from synergy effects, but what else made several airlines choose the 'takeover strategy' in the last 10 years in Europe? Is consolidation the only possible solution for small Eastern European flag carriers, too? The first section of this paper investigates why airlines prefer consolidation and questions whether consolidation was the only way to survive.

Most of the Eastern European airlines are still (or again like Malév) publicly owned and regulated by the same governmental institution. This raises questions like how effectively a former national monopoly can compete if regulation and ownership are not separated and how long a national carrier can be subsidized? In the second section, this paper will look at the historical and financial improvement of Eastern European flag carriers after the political changes in 1990. Finally, by analysing financial data the paper describes the case of Malév Hungarian Airline.

The research paper provides an understanding of the past and an overview about the future airline strategies in the Eastern part of Europe.

Keywords: airline strategy, Eastern Europe, ownership structure, state aid, regulation

1. Understanding the background of the consolidation wave: airline economics

Airlines are fear to fail, but probably they are even more afraid of being taken over. However, there is a consolidation wave in the European airline industry started with Air France - -KLM in 2004 and Eastern European carrier are now affected. Therefore, there is an important need to understand the economics of consolidation.

The research will draft special features in aviation. We describe the driving forces behind consolidation from the airlines perspective and in the remaining part of the paper we compare the results to the flag carriers for management purposes. The aim of the first part of the research is to map threats and opportunities for airlines and provide them a better understanding in consequences of a potentially takeover.

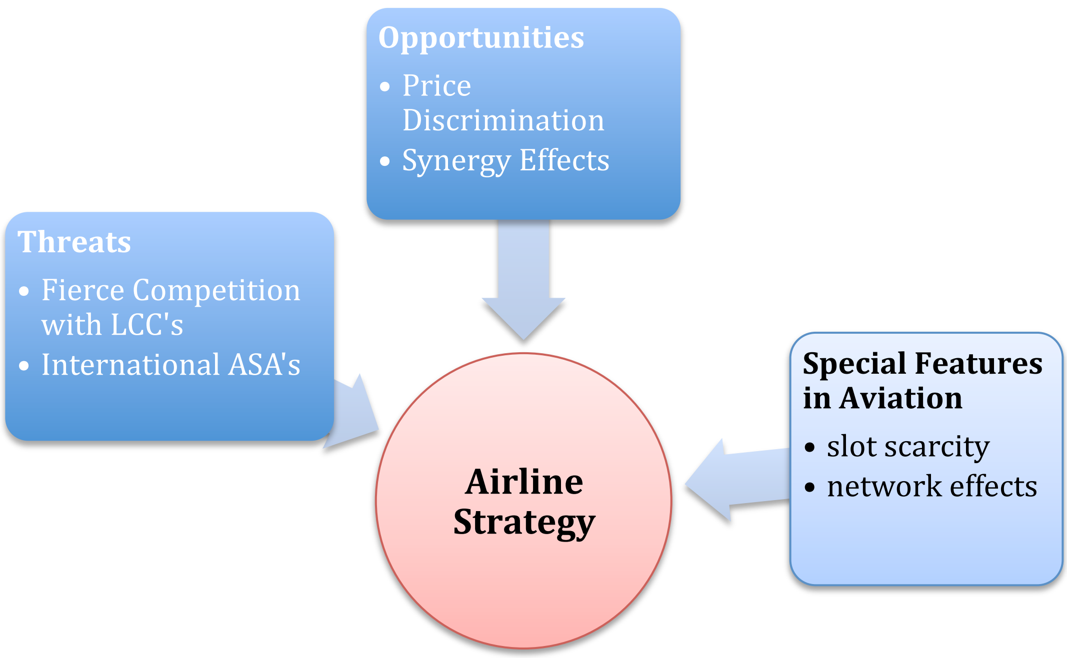
1.1. Introduction: driving forces behind the consolidation

From the managers point of view the bigger the company, the higher the achievable profits. Airlines can benefits from price discrimination and synergy effects. Bigger airlines can provide higher quality service by better scheduling, reciprocity of frequent flyer programmes (FFPs), they can use fare combinability, and joint corporate contracts.

On the other side, airlines nowadays have to face fierce competition, especially from Low Cost Carriers (LCC). Budget airlines are strong competitors not only for traditional network carriers, but for the smaller so-called flag carriers.

Flag carriers are national carriers in mainly state-ownership. The situation of former national monopoly airlines in Eastern Europe is a very special one. After the EU-accession of ten Eastern European Countries in 2004 and 2007, small national carriers had to give up their former international air service agreements (ASA's) and had to implement new rules. Some of them could not keep the increasing competition and failed. The figure below shows the threats and the opportunities for Eastern European carriers to survive.

1. Figure: Implementing Airline Strategy



Source: Own figure

From the economist's point of view there are other special features in aviation, as well. Thanks to network effects, like economies of scale and scope or traffic density bigger airline could provide lower fares. Airlines save costs due to economies of density and elimination of double marginalisation. We start the analysis with these issues.

1. 2. **The Economist's Point of View: Why consolidation is not necessarily bad**

At the university we first study then teach about the perfect world with perfect competition. If network externalities (economies of scale and traffic density[1]) are present, perfect competition is not efficient any more. Since competition would include a smaller-sized network with higher marginal cost.

As first in the literature (Brueckner & Spiller, 1991) have drawn attention to the network effects in the air transport. The authors argue that if increasing returns are strong (there are economies of scale) and the demand for a given route is high, a merger of the hub airline and a competitor raises total surplus.

The merger might reduce welfare on the overlapping route, but passengers on related routes will definitely benefit from cost complementarities. Due to the network externalities and especially to economies of scale the merged airline will operate with lower marginal costs. Thus the authors recommend taking the welfare gains in 'outsider' markets also into account, since benefits from the merger can spillover even other routes.

Airlines also aim to improve their network and tie more consumers with bonus schemes, like frequent flyer programs (economies of scope). Therefore the load factor of the aircraft, thus the traffic density on a given route increases and the airline can achieve cost efficiencies. Also the airports benefit from economies of traffic density, since the additional traffic lowers the average cost of operating the infrastructural facilities (Wolf, 2001).

This efficiency gain and cost reduction could lead to lower ticket prices and an increase in consumer welfare. Airlines could use lower marginal costs to lessen the prices and increase the ticket sales with it.

'*What is worse than monopoly? A chain of monopolies'* (Tirole, 1988) introduces the problem of double marginalisation with this old saying. A vertical relationship exists between airlines operating on complementary routes. If two airlines with monopoly power operate independently on these routes, they impose externalities for each other. These reduce the common profit and lead to lost efficiency. Taking the pricing decision together however reduces the costs, increases the total output, thus beneficial for everyone. In that way vertical mergers can lead to efficiency improvements and increased social welfare. This Chicago School theory revolutionary has changed the US antitrust policy in the 1980s.

Vertically integrated monopolists provide better quality, higher quantity and lower prices by using price differentiation and by avoiding double marginalisation (Economides, 1996). Since airlines will increase their profits, there is an increasing need for consolidation in the aviation industry.

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[1] Tretheway and Oum define economies of traffic density as 'cost per passenger declines as the number of passengers per station increases' (1992. p.10).

1. 3. The Management Point of View: Synergy Effects

Airline managers claim significant cost and revenue synergies concerning the consolidation. Reciprocity of FFP's, combined fares, joint corporate contracts, integrated scheduling and IT system, common catering, maintenance and operations are the most common synergies in order to clarify higher quality service.
Almost all of these benefits could be gained from a simple alliance, with the only exemption of combined fares. Only the merged entity can optimize the common profit by setting the price together. Thus, the main reason behind the consolidation is the common revenue management and pricing.

The following figure provides an overview on the claimed benefits of the Lufthansa merger cases from 2005 to 2009. As we can see on the figure, the synergies are not the only reasons behind the mergers. Another important reasons are network effects and the direct access to the partner's source resources, like new markets and slots at congested airports.

1. Figure: Benefits from the mergers with Lufthansa, claimed by the parties

The proposed synergies stem from:	**Swiss**	**BMI**	**Brussels**	**Austrian**
Code-share between the countries	X		X	X
Multiple hub strategy: increasing network quality and higher flexibility, lounge access and ground processes, more frequencies, more destinations, realigned timetables, better connections	X	X	X	
New market access, additional destinations		X	X	X
Network effects by extension of hub connections, traffic increase and better capacity utilization, more feeder and transit services				X
Slot-share		X		
Amount forecasted by Lufthansa	€470m in three years	€127m annual	'mid-double digit' annual	€80m annual

Source: different EU COM decisions on Lufthansa mergers

Especially the Lufthansa/ Swiss merger was a success story. Lufthansa has taken over the Swiss national carrier in 2005, after Swiss was restructured. The joint operation brought both airlines millions of costs- and revenue synergies, more than expected before.

1. Figure: Synergies generated by the LH/ SWISS merger (in million €)

YEAR	Forecasted by LH in 2005		Forecasted by LH in 2006		Realised according to Annual Report/ Press Release
Source	Revenue	Costs	Revenue	Costs	
2005	15	15	14	18	32
2006	32	40	77	73	200
2007	86	70	80	94	233

Source: Deutsche Lufthansa AG (2005), SWISS (2005), SWISS (2007)

Cost synergies allow airlines to save money and eliminate double marginalisation, which could lead to lower fares or higher profit margin. Whether the airline could decrease the fares depends on the market structure and on the speed of the adaptability of the new management. However, whether the airline would decrease the fares is up to its market power and the affectivity of competition policy.

2. Airline strategies in Eastern Europe: state aid, privatisation and renationalisation

Eastern European carriers are now facing a new wave of airline consolidation and have to be prepared. As there is no official definition of Eastern Europe, the paper focuses on the new EU member countries from the Eastern part of Europe. In 2004 Poland, Czech Republic, Hungary, Lithuania, Latvia, Estonia, Slovenia and Slovakia entered the EU[2].

Most of these national carriers are still carrying heavy losses from the past and old management structure. Some of them have been already privatised, but unfortunately all the privatisation attempts failed and the flag carriers now have to look for new perspectives. In 2011 many of these countries are short before a new privatisation or consolidation wave, which might mean their last chance to stay in the market.

In this chapter we are looking for the question, how effectively a former national monopoly can compete if regulation and ownership are not separated and how long a national carrier can be subsidized. The paper provides case study evidence on different airline strategies from Eastern Europe. As we will see, the problems of state injections or state aid are not unknown from the earlier airline history.

2. 1. Subsidising the national "champions"

According to the definition of state aid (EU COM, 2008a, Article 107 of the Treaty, p.91):
"any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market".

In the 1990's the European Commission had many cases concerning illegal state aid to the national giant companies, the so-called national "champions". The highest state budget among all the relevant airlines has received Air France. An important difference between the classifications of state was the amount of the capital injections. While negative decisions were taken in the upper class of financing, small amounts of capital injections were not classified as state aid in general. Not only public airlines, but even the privately owned "big three", British Airways, Lufthansa and KLM were rescued by capital increases.

With the exemption of AOM (a French airline) and Sabena all of the airlines on the EU state aid "black list" are still operating. In addition, Swissair has taken over AOM (this time Swissair hold nearly 50 per cent in Sabena) in 1999 and went to bankrupt with them together in 2002. However, after the insolvency Swissair was rebuilt as Swiss and operates now (as part of Lufthansa) successfully.

2. State aid and capital injections among European airlines in the 1990's

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[2] Romania and Bulgaria have entered into the European Union in 2007, however the paper does not analyse these countries, because they need further research.

Airline	Year	Budget (m USD)	Decision
Sabena	1991	1 800	Commission-approved state aid
Iberia	1992	830	
Aer Lingus	1993	240	
TAP	1994	1 965	
Air France	1994	3 300	
Olympic	1994	2 245	
Alitalia	1997	1 708	
Air France	1991	338	Not classified as state aid
Sabena	1995	267	
AOM	1995	49	
Iberia	1995	593	
British Airways	1993	690	Private sector
KLM	1994	620	
Lufthansa	1994	710	
Finnair	1992/4/5	175	

Source: (Doganis, 2006)

When studying the recent EU COM decisions, we can find many similarities to the past airline cases. Olympic Airlines and Alitalia are the most interesting ones. Olympic airlines had many troubles with competition policy in the last 20 years. Greece was first founded guilty in 1994 in financing the loss-making national carrier. After its second EU COM state aid investigation case with immediately recovery decision Olympic was re-organised in 2003 and started a new life as Olympic Airlines. Even in its first year of operation in 2004 Olympic Airlines had a loss of € 87.1m. The airline could not recover in the coming years, in 2005 the losses went up to €123.7m and in 2006 over € 120m (EU COM, 2008b).

Not surprisingly, the airline has never paid back its illegal subsidiary to Greece. Moreover, Greece offered a new rescue package for Olympic in 2006, which was find illegal, again. In the most recent state aid proceedings, the Commission obligated the airline to pay back more than € 850m to Greece. In order to survive, Olympic decided to merge with Aegean, but unfortunately for the airline, the EU COM rejected the merger in 2011.

In its second investigation, the EU COM found Italy guilty in illegally subsidizing its national carrier, Alitalia. However, according to (Beria et al., 2011) Alitalia has received state loans many times. One year after the EU COM decision, Alitalia received a capital injection of € 1 billion (half from Italy and half from investors) in order to pay back the previous loan. By this time Alitalia was making daily € 2m losses.

Alitalia, similarly to Malév (see in the next chapter), had many tries to be privatised and re-nationalised. The first effort was in 2003, when the unions did not accept the offer and the privatisation failed. Alitalia was heavily loss making in 2006 (€ 626m) and in 2007 (€ 495m).

In 2008, Air France - KLM offered a bid for purchasing 100 per cent shares in Alitalia, but the Italian rejected the offer from political reasons. Finally, in 2009 Air France - KLM bought 25 per cent shares in Alitalia for € 32 m (Beria et al., 2011)

The Portuguese government gave TAP a second financial assistance by the government; this was not a state aid indeed. However, according to the huge debt of the state, Portugal has to privatise its 100 per cent flag carrier soon.

In the case of Air Malta the financial assistance did not raise any objections. However, the airline is loosing money since 2003. Its operating losses were in 2003 €20m; in 2008 "only" € 8m, in 2009 € 34m, and in 2010 € 23m. The following figure provides an overview on the latest state aid cases in Europe.

3. EU COM State Aid cases concerning national carriers

Airline	Year	Budget (m EUR)	Decision
TAP Portugal	2000	-	Raises no objections
Sabena	2001	13.16	Positive *on training aid*
Olympic Airways, as	2002	41	Negative with recovery
from 2003	2006	493.25	Negative with recovery
Olympic Airlines	2008	856.5	Negative with recovery
Alitalia	2008	300-400	Negative with recovery
Cyprus Air	2007	24.3	Positive decision *on restructuring plan*
Austrian Airlines	2009	200	Positive decision
Air Malta	2010	52	Raises no objections: *on state loan*
Malév	2010	308,7– 386,9	Open *on state loan and capital increases*
CSA Czech Airlines	2011	94	Open *on state loan*

Source: own figure based on EU COM state aid investigations

2. 2. Historical improvement of Eastern European airlines after 1990

After the political changes in the early 1990s Eastern Europe had to face with new tasks, e. g. privatising the huge state owned companies and let competition in from abroad.

The first country to sell its national airline was Czech Republic. The first attempt to sell CSA' shares failed two years after Air France partly invested in the Czech flag carrier. The state re-nationalised CSA in 1994. The second privatisation experiment took place in 2009. Air France - KLM and Aeroflot were interested as well, but only Unimex Travel Service induced an offer.

Because of its small bid of € 40m, the state rejected the offer. CSA seems to looking for other strategies to rescue the airline, since June 2010 the CSA charter has been outsourced for the Holidays Czech Airlines.

4. Ownership structure of Eastern European flag carriers

Airline	Country	Privatised in	Renationalised in	Alliance partner since	State ownership (in per cent)
CSA	Czech Republic	1992 partly for Air France	1994	SkyTeam 2001	95.67
LOT	Poland	1999 partly for Swissair	2001 and 2009	Star Alliance 2003	68
Malév	Hungary	2007	2010	Oneworld 2007	95
Tarom	Romania	-	-	SkyTeam 2010	95
Adria	Slovenia	-	-	Star Alliance 2010	87.7

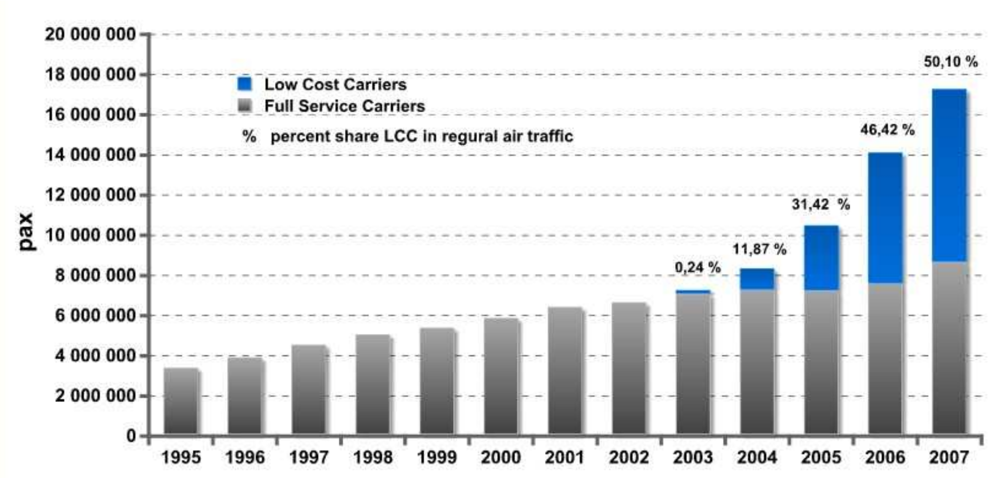
Source: on ownership structure (AEA, 2010)

The table above shows the ownership structure, the privatisation attempts and the re-nationalising of Eastern European flag carrier in chronological order.

Firstly, Swissair privatised LOT Polish Airlines in 1999. The airline has bought 10 per cent in LOT and until 2001 Swissair has increased its shares up to 37.6 per cent, while the Polish government had 52 per cent. After its bankruptcy and restructuring as Swiss in 2002, the Polish government partly renationalised the flag carrier. (Doganis, 2006). LOT, like we could see at CSA charter, established an own LCC, Centralwings in 2005. Unfortunately, the strategy failed in the fierce competition with other LCC's entered the Polish market and Centralwings went bankrupt in 2009.

The market share of LOT Polish Airline has decreased from 91 per cent in 1990 to 32 per cent in 2007. As the following figure shows, the market share of LCC's on the Polish aviation market was over 50 per cent in 2007.

1. Regular air traffic and LCC market share in Poland



Source: (Huderek-Glapska, 2010)

We will describe Malév in details in the next chapter. There is less to say to Tarom, which was a monopoly in Romania until WizzAir has entered the market in 2006. Recently in August 2011 the government approved a privatisation plan on 20 per cent of the shares.

In Slovenia, a new restructuring plan is coming. In 2009 Adria Airways lost 21 per cent operational revenue, and 13 per cent o its passengers compared to the year before. In 2010 the new management sold the airlines shares in Adria Technika (maintenance) to Ljubljana Airport and the government.

Slovakia has no flag carrier any more. Slovak Airlines was operating until 2007. In 2005 Austrian Airlines bought 62 per cent, but the new owner has withdrawn its financial support afterwards and the airline went into bankruptcy. A Slovak charter, Seagle Air took over the former flag carrier, but it went into bankruptcy as well in January 2010.

Lithuanian Airline was privatised in 2005 due to its losses and started its career as FlyLAL. At the beginning the airline was successful, it has increased its passenger number by 9 per cent in 2006. The ticket prices went down by 7 per cent, and FlyLAL could achieve savings of € 43m. However, FlyLAL had to face with the liberalised EU market soon. The airline could have entered other markets, but other airlines, like airBaltic could have entered the Lithuanian market as well. FlyLAL decided to establish an own charter, which is still operating as Small Planet. Since 2010 the charter focuses on destinations in only 4 countries and this strategy seems to work well.

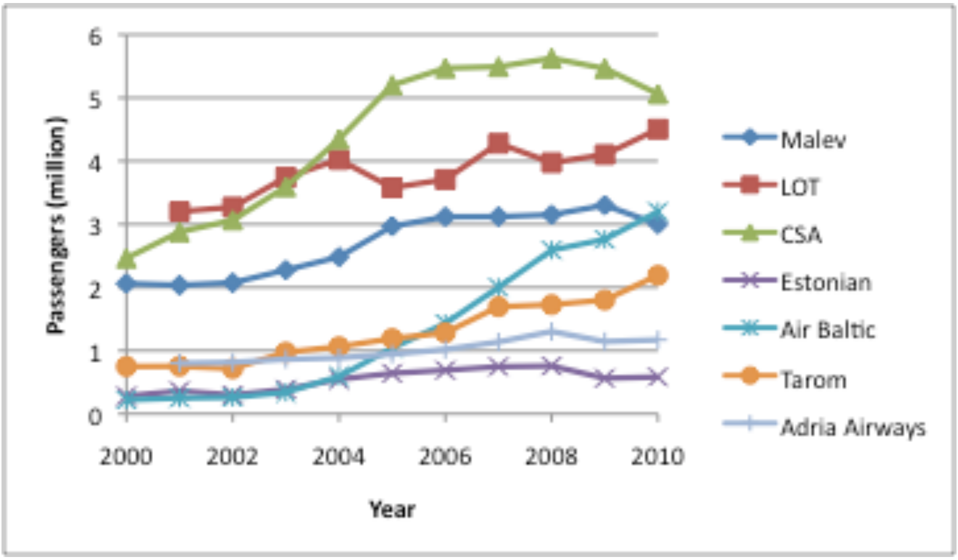
On the other side, FlyLAL had to announce insolvency in 2009. The negotiations with Swiss Capital Holding failed. The company had 51 per cent private ownership in 2009, when the shareholders offered to sell all shares for 1 LVL (€ 0.7) per share and asked the government to give them € 8.7 m loan. The Transport Ministry of Lithuania refused the deal and FlyLAL went bankrupt in January 2009.

The main problem with FlyLAL was, that until the very last days the airline was focusing on consumer satisfaction and did not realize the importance of LCC strategies.

2. 3. Financial improvement of Eastern European carriers

As we can see on the figure below, there is no significant sign of global financial crisis, 11th September, EU membership or alliance partnership concerning the carried passengers. All of the Eastern European flag carrier, who survived, could slightly increase the passenger numbers. Malév data is moving together with CSA, while Tarom follows the LOT tendency.

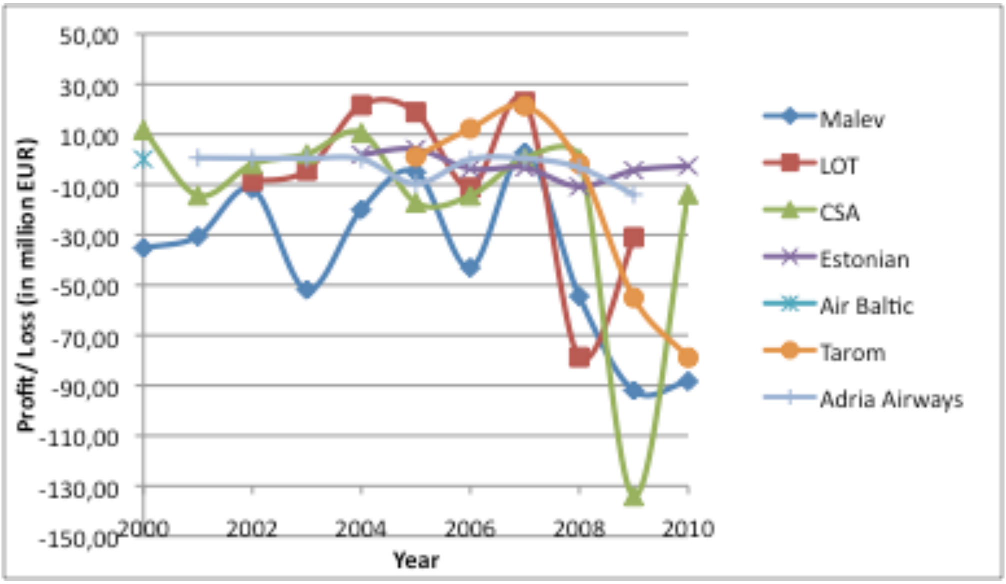
2. Number of Revenue Passengers



Source: Own calculations based on Annual Reports

The extensive success of airBaltic can be partly explained by the fall of FlyLAL in 2009. However, the Latvian airline seems to be falling over now. In September 2011 airBAltic requested bankruptcy protection in order to win time to pay back the loans to its creditors. It is an interesting issue, because the airline reported €344m profit in 2009 (BBN, 2010). The government ensured the airline to increase its share capital, “Prime Minister Valdis Dombrovskis is confident that national airline airBaltic must remain a national airline of Latvia” (Petrova, 2011).

3. Profit / Loss of Eastern European Airlines between 2000 and 2010 (in million EUR)



Source: own calculations based on Annual Reports

Due to the increasing passenger numbers the airlines operate well. Unfortunately we cannot state the same objection, if we look at the financial data, especially the profit and the losses from the company's balance sheets.

The only profit-making airline among our sample in 2010 was Estonian Air. This was not always the case, since Estonian was loosing money since Estonia's EU membership from 2004. In 2009 SAS, who owned 49 per cent in Estonian since 2003, decided to sell the loss-making airline. According to (The Economist, 2009), Chinese investors expressed interest in purchasing Estonian Air, because "Beijing would be glad to have some more allies in the EU or in its waiting room." By mischance of China, the Estonian government renationalised the airline in 2010.

Chinese investors are now interested in buying Malév Hungarian Airlines. In the next part of the paper we are going to describe, how Malév was performing in the last 20 years and how did it came to the situation, that Chinese investors are knocking on the door of the EU aviation market, now in Hungary.

3. Case Study: Malév Hungarian Airlines

Malév is a very special flag carrier, since the airline was first partially privatized in 1992 then re-privatized in 1997. Between 1999 and 2007 the airline was solely in state ownership. Malév became a member of the oneworld alliance in 2007.

The latest history of Malév is even more interesting, because the second privatization attempt failed again, thus the airline is state owned since February 2010. As a loss making national carrier Malév has lost again around nine percent of its passengers in 2010. The operating revenue has been decreasing for years. In addition, in March 2010 WizzAir claimed Hungary against the second re-privatization at the European Commission. At the same time Malév has won the "Best Eastern European Airline" price from the World Airline Award.

How did the alliance membership improve the prospects of the airline? What properties keep Malév and the Eastern European Airlines alive and how sustainable are they? Will Hungary keep its flag carrier or will Malév be taken over by another (Western European) airline? This section of the paper will investigate all of these questions.

3.1. Brief history of privatisation(s) and re-nationalisation(s)

According to (Malev, 2011) the early history of the airline began in 1946 with an agreement as Maszovlet (Hungarian-Soviet Civil Airline Company). After 4 years of joint operation, by the time when Budapest Airport was built, in 1950 Malév has started independent services as well. Its first “Western” flight was to Wien in 1956. Since 1969 Malév has no more domestic destinations.

In 1984 Malév became a member of IATA (International Air Transport Association.) After the political changes in 1989 in Hungary, Malév, like many state-owned companies was partly offered for privatisation. In 1992 an Italian public consortium of Alitalia and Simest received 35 per cent of the airline’s shares and parallel with the deal Malév became a joint stock company.

However, couple years later the first privatisation experiment failed[3] and in 1997 two Hungarian privately owned banks (OTP[4] and MKB[5]) bought back the airline shares. From different (mainly political and less academic) reasons Hungary decided to re-nationalise the airline in 1999 and purchased back its shares up to 97 per cent (EU COM, 2010).

1999 was the last year, when Malév could write black numbers. However, the almost € 20m profit from the year 1999 might have been probably a result of the governmental financial injection. Later in this section, the paper will analyse the financial data in details.

Solely because of its worsened monetary performance, Hungary had no other choice, but privatise the airline again and hope for a better enforcement. After numerous attempts[6] starting with 2000, finally in February 2007 Malév was in 99.95 per cent sold to a company, named AirBridge[7]. For a better comprehension see the figure below.

4. First and second privatization of Malév Hungarian Airline

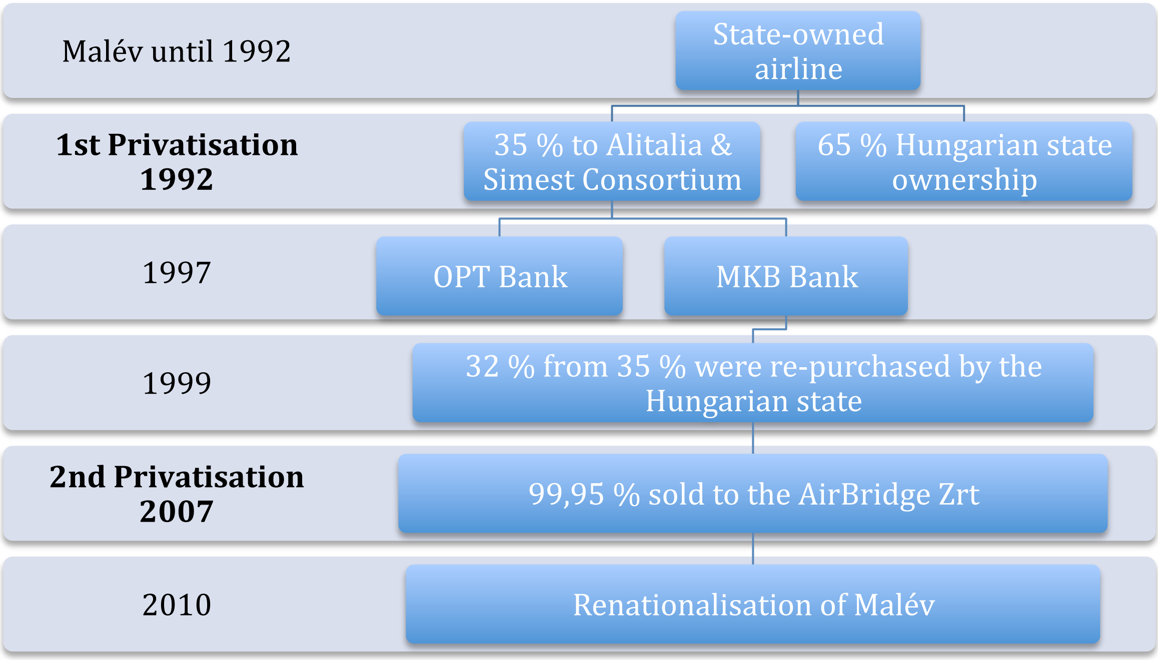
[3] Unfortunately the reason is not clear, because after almost 20 years the privatisation agreement is still a confidental governmental document.

[4] Országos Takarékpénztár

[5] Magyar Külkereskedelmi Bank

[6] In 2000 despite the 20 airline applications for Malév, the10 per cent shares privatisation failed; in 2004 privatization of 99.95 per cent Malév shares did not succeed, but only Aviation Solution Ltd was interested; in 2005 the same 99.95 per cent privatization failed, hereby the applicants were ASBK Ltd. and AirBridge. In 2006 In 2006 LAL was interested in buying shares in Malév.

[7] Air Bridge was 49 per cent owned by VEB (Vnesheconombank, a Russian state-owned bank) and 51 per cent of two Hungarian individuals.



Source: own figure based on (EU COM, 2010)

According to the global financial crisis and the bankruptcies of more own Russian airlines in 2008, VEB decided to "continue finance Malév, but as a bank and not as an owner." (EU COM, 2010, p.4).

Therefore, three years later, in February 2010 Malév was re-nationalised again. There were diverse reasons, why the Hungarian state decided to re-purchase the flag carrier. This paper does not aim to describe the legal, the political or the emotional reasons, but tries to give a better understanding based on the airline's financial issues.

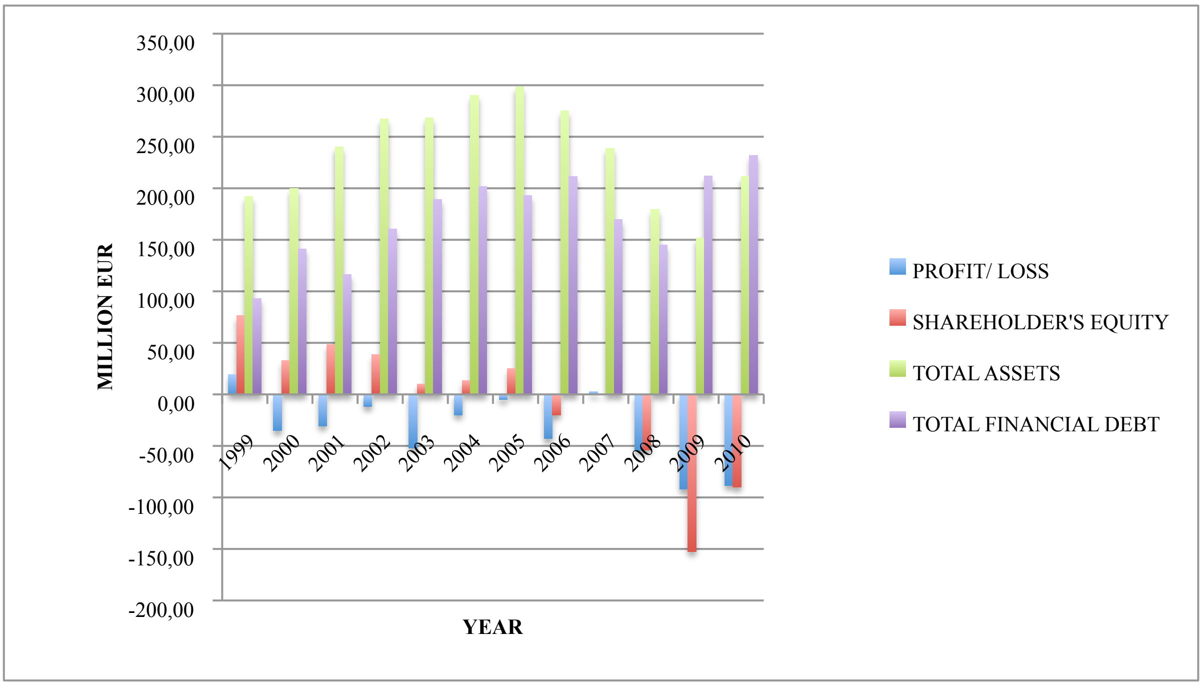
3. 2. Financial development of Malév

Malév was not profitable in the last 10 years. Starting with 2008 the amount of the total financial debt was over the total assets of the company.

Thus, the debt – to - equity ratio has been worsened in the last years dramatically down to -2,581 in 2010, thus more than risky. The total financial debt of the company is increasing from year to year and achieved an extreme amount of € 232m in 2010. Compared to this FlyLAL had $ 35m, while Alitalia 1.36 billion debt before their insolvency in 2008.

In spite of the numerous capitals increases by the Hungarian government, the shareholder's equity has been negative since 2006 (with an exemption of 2007, when it was € 350.000). The following figure represents the airline's financial performance in the last 10 years.

1. Financial situation of Malév between 1999 and 2010



Source: EU COM (2010) and Malév Annual Reports from 2000-2010

In order to get a whole picture, we must take into account the financial injections from the government. In 2002 Malév has received € 32.2m from the Hungarian state, which was followed by an other € 14.3m capital increase. This might explain the less losses in these two years. In 2007 Malév had a positive account of €2,77m profit. However, that might have been thanks to a state loan, which we are going to explain in details a little bit later in this paper.

According to the figures, there was no significant effect of September 11th in 2001. Moreover, the airline has performed "better" (less bad), than the year before. Instead of € 35m in 2000, in 2011 Malév has written only € 30m losses. The paper is not concerned with the effects of the global financial crisis, since not only Malév, but also all carriers were affected more less by the same situation.

Interesting is however the affect from the EU - accession of Hungary in May 2004. The liberalised aviation market among the European Union was carrying advantages and disadvantages as well. As a positive feature, no bilateral agreements were needed any more to enter a new market. Additional destinations in new countries were free for Malév to enter, as long as they are not slot-coordinated of course. This year should have been the time to re-positioning the national carrier and to use the opportunities to increase Malév's market share in abroad.

On the other side, entering the EU has raised numbers of questions, like:

- Does it mean loosing the former bilateral agreements?
- Liberalization brings new market entry to Hungary as well, thus loosing passengers and market shares of Malév? What are Malév's competitive advantages?
- New entry on the ground handling services means competition for Malév Ground Handling? What are its consequences and how to deal with it?
- Due to EU aviation agreements is there a development of passenger rights necessary?
- How costly is to apply the new EU rules?
- Question of the necessary capital increases, is it automatically state aid?

In lack of expertise on air transport economics issues these questions became the main problems of Hungarian aviation after 2004. Especially the problem with the state aid is a very serious one. In the following part of the paper we describe the current EU procedure concerning state aid Malév vs. Hungary.

3. 3. State aid Malév versus Hungary

Since Malév has seemed to be fail in the European aviation market with increasing competition, the easiest way was to grant new finances and rescue the national airline. More times.

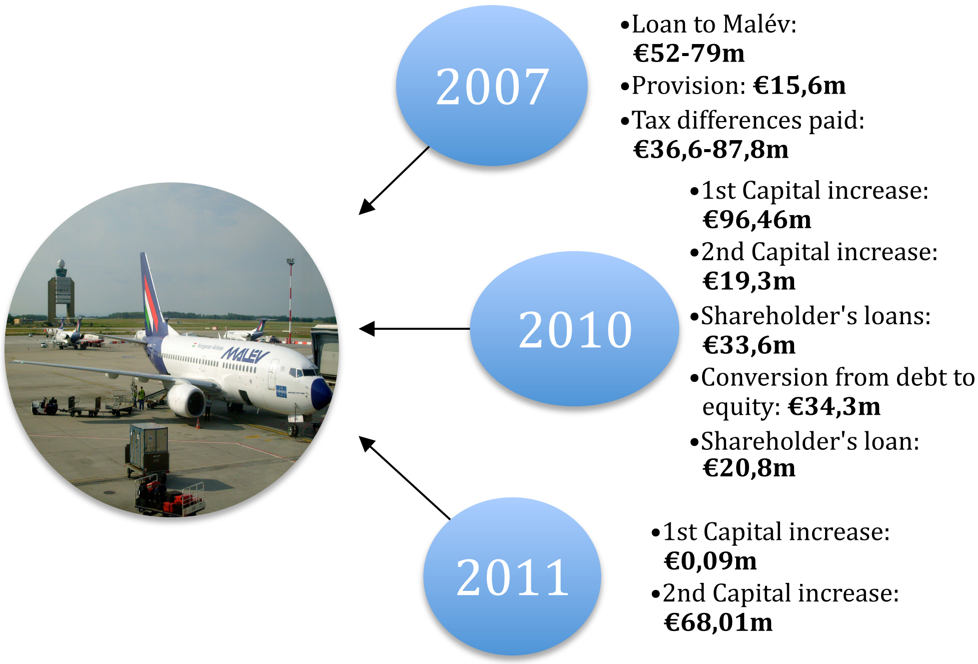
As we could seen from the previous chapter, governmental financing were common not only in Eastern European, but in many European countries. Furthermore, all of the airlines listed before are still in the market in 2011, thus a state aid process does not automatically mean the end of an airline. However, some of these airlines had to be re-structured and a few of them had to be rebranded in order to survive.

Concentrating on Malév Hungarian Airlines the paper now introduces the recent airline state aid procedure in the EU Commission. The process started in March 2010 when Hungary confirmed the EU COM about the re-nationalising and capital increasing in Malév. A few days later WizzAir, the other Hungarian (low cost) carrier announced a complaint at Commission about illegal state aid to Malév. After all, Hungary reported the EU COM to restructure the airline. It was followed by a second complaint from WizzAir in October 2010, which has ended up in an official state aid procedure against Hungary (EU COM, 2010).

Due to the current stand of the facts in September 2011, the EU COM has doubts whether Malév would have given financing from the market. If no market finances had been available, this would be an illegal state aid issue, and Hungary would have to deal with the consequences. In this case Malév would have to pay back the state the whole sum of the amounts below, at least.

The following figure provides an overview on the EU COM state aid procedure Hungary versus Malév.

1. State aid investigation for Malév



Source: own figure based on EU COM (2010) and (HVG, 2011)

Taking into account the current monetary situation of the airline (€ 230m financial debt plus yearly € 100m losses), it is almost impossible to receive another loan to pay back around € 308,7m – € 386,9m. Moreover, the current EU investigation does not contain the most recently capital increases of €68,1m together in April and in August 2011. All these together would force Malév into bankruptcy.

However, if the parties can provide evidence on former market investigators interested in Malév, the airline can (shortly) survive. The possibility of this option is low. By the way, after Hungary has received an official letter from the (EU COM, 2011) in May 2011, suddenly two interested companies appeared:

- Consortium of Unimex Group, Travel Service[8] and LCC Smartwings (Czech Republic) and
- Hainan Airlines (China): They would prefer a new airline indeed.

Previously in 2006, the Czech consortium has applied for taking over CSA as well. (HVG, 2011). Since as a non-EU country China is not allowed to have more than 49 per cent shares in a European airline, the solution might be a common shareholding with the Czech consortium. The only question remained is *when* Hungary is going (or has) to decide to sell its flag carrier.

3. 4. Strengths and weaknesses of Malév

Malév became a member of the oneworld alliance in April 2007. The membership has definitely improved the airline's prospects, however there is no consensus on the exactly additional value among experts. While Martin Gauss, the former CEO of Malév stated yearly 300-350 thousand additional passengers, thus 10 per cent of all, a Hungarian elite newspaper (Varga G., 2010) counted only yearly 3 per cent of all passengers

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[8] Czech charter airline with 32 aircraft and 230 destinations in sommer

Fortunately the additional destinations are easier countable; there are nearly 750 destinations, 150 countries thanks to the alliance membership.

According to an interview with Martin Gauss, former CEO of Malév (Gauss, 2009), the airline as only 21 per cent of its operational revenues from Hungary, the most revenue come from the transfer business. 50 per cent of the passengers use Budapest Airport only for transfer.

Despite the high transfer ratio, in 2010 Malév has worsened its transfer time (one third of the transfer flights now belong to the 90-120 minutes zone) and lost passengers flying from the Balkan States, Eastern and Southern origins to Scandinavia and Western destination (Varga G., 2010).

Destinations that cannot cover the marginal costs (Varga G., 2010):

- *2009:* Targu Mures, Iasi, Jekatyerinburg, Belgrade, Sarajevo, Genf and Zurich
- *2010:* Targu Mures, Uzhgorod, Larnaca, Pristina, Skopje, Tirana, Varna, Sarajevo, Belgrade, Odessa, Split, Stuttgart, Göteburg, Paris, Zurich, Rome and Milan

Under Gauss's leadership Malév has reduced its aircraft from five different types to only two types. Furthermore, the airline has offered tickets at a bargain price, like its LCC competitors. In 2009 the load factor has increased up to 65 per cent, however, a reason behind might be the replacement of the bigger aircraft Boing 767 to the smaller 737.

The most prosperous routes in 2009 from Budapest (Varga G., 2009):

- Bukarest, Tel-Aviv, Bejruth, Damaskus, Belgrade?

In 2009 Martin Gauss introduced a business plan that described how to achieve profitability "after" 2011. He counted with operational profit and 4 million passengers for the year 2012. (Varga G., 2009). Unfortunately he cannot enjoy the results, because he resigned his position in May 2011.

Malév is not only an airline. It is 100 per cent owner of its subsidiary Malév Ground Handling[9], Aeroplex maintenance and MA Regionális Légitársaság Kft (AEA, 2010).

According to Gauss (2009) Malév has 44 per cent market share on Budapest Airport. The airport handled 8 million passengers in 2010, from which 26 per cent have travelled with LCC's. Malév's Hungarian rival Wizzair served 800 000 passengers in 2009.

Thanks to the new modern terminal SkyCourt and a further development of Terminal 2, Budapest Airport counts with 15 million passengers by 2015. Since the airport capacity is going to grow very fast, Malév could get a new chance to strengthen its nearly 50 per cent position and keep its market share on Budapest Airport.

The airline had many good opportunities in the past, but was not always able to live with them. At latest, Malév was awarded "The Quietest Airline 2010" prize by senior executives of Prague airport. In case Malév does not wake up and catch the early birds opportunity, it might become the quietest airline for a long - long time.

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[9] The company was sold in January 2009 to MNV Rt (Hungarian State Holding company) for € 15,6m in advance, but in July 2009 MNV Rt[9] has withdrawn the deal, however unfortunately MNV Rt. has never received the advance payments back EU COM (2010).

Conclusion

This research has provided a short overview on threats and chances, flag carriers have to face in the new environment. By describing the evidence, the paper tried to give a better understanding for management purposes concerning Eastern European airlines.

The EU accession has opened new markets, but pose a further challenge for smaller airlines, who have experienced the liberalised European market as a disadvantage compared to LCC's In the previous ten years, numerous LCC's entered the market and some national carriers were rescued by state aid.

Governments seem to prefer maintaining their loss making national flag carriers and pay a high price for them. According to the recent EU COM investigation, Malév probably has to recover its financial assistance back to Hungary in an amount above € 300m. However, as we have seen on the case evidence (Greece or Italy), state financing can be sustainable and flag carriers can survive. At least they can live longer without any restructuring. On the other side, we have proved that an airline (like Swiss) can achieve better performance after having been reorganised.

We have seen many different airline strategies in the eight new member states, we have described. Some carriers have established own LCC and tried to focus on fewer destinations. LOT's LCC Centralwings failed after 4 years operations, but LCC Small Planet has outlived its founder airline, FlyLAL. All in all, the "perfect" airline strategy is individual in the light of the cross-country differences and needs further research.

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