Organizational learning, operating costs and airline consolidation policy in the Chinese airline industry

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A B S T R A C T
This study investigated and reviewed organizational learning in the Chinese airline industry, which is dominated by state-owned or state-controlled airlines. This empirical research focused on the extensive scale of airline mergers and acquisitions among 12 Chinese airlines for the period of 1996–2014. This research aims to make a contribution towards addressing the general lack of academic reflection on the impact of organizational learning on airline performance during and after the completion of mergers and acquisitions. The empirical findings of this paper suggested that there was, in general, organizational learning experienced by Chinese airlines from their prior operating experience in improving operating costs. However, airline mergers in 2001/02 increased airlines’ average operating costs, as most state-owned airlines are notorious for poor cost management. Significantly, the performance improvement among Chinese airlines was found during the post-merger periods in this study, and the increase in Chinese airlines’ operating costs during the post-acquisition periods due to the limited integration of 2010 acquisition compared with the 2001/02 mergers.

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1. Introduction

Global investments in mergers and acquisitions (domestic or cross-border) have reached unprecedented levels in recent years. These two strategic business activities have become popular strategies undertaken by business organizations (including airlines) for entering and/or expanding new markets, as well as for maintaining their existing market position (Haleblian et al., 2009; Hitt et al., 1998; Németh and Niemeier, 2012). Prior literature has examined the consequences of these two specific strategic growth strategies on various dimensions of organizational performance, including stock returns (Bhabra and Huang, 2013), profitability (Epstein, 2004), firm value (Du and Boateng, 2015), and changes in the operating performance of target firms (Bertrand and Zitouna, 2008; Buckley et al., 2014). In the context of the airline industry, Merkert and Morrell (2012) claimed that mergers and acquisitions seem to be “game-changers” and are mandatory to survive in the highly competitive aviation markets, allowing airlines to gain access and slots at the key airports and leverage synergies. Many airline mergers and acquisitions have happened around the globe after 2000, including Air France/KLM (2004), China Eastern Airlines/Shanghai Airlines (2010), Delta Airlines/Northwest Airlines (2009), United Airlines/Continental Airlines (2010), and British Airways/Iberia (2011).

The impact of organizational learning upon an organization’s performance has been an important topic of organizational studies and management practice, as many prior studies have argued that organizational learning can affect and improve the performance of an organization, such as new product development (creativity and innovation) and the creation of a learning culture within the organization (e.g. Murray and Donegan, 2003; Yeo, 2003). Researchers have defined organizational learning in many different ways. Firstly, organizational learning is defined as “a dynamic process of creation, acquisition, and integration of knowledge aimed at the development of resources and capabilities that contribute to better organizational performance” (López et al., 2005, p.228). Secondly, organizational learning occurs as an
organization acquires experience (Argote, 2011; Argote and Miron-Spektor, 2011). For example, an organization's experience can be obtained from experience of success and failure or the past (Kim et al., 2009). In this respect, organizations like airlines are also seen to learn from prior experience of accidents and incidents in improving flight safety (Haunschild and Sullivan, 2002). Apart from prior experience, there are other factors that may also affect the phenomenon of organizational learning throughout the learning curve, such as pre-production planning activities, time, employee training and selection (Chambers and Johnston, 2000). More importantly, Argote and Miron-Spektor (2011) claimed that:

“organizational learning is so central to organizations and their prosperity, so a great understanding of organizational learning promises both to advance organization theory and contribute to improve organizational practice” (p. 1131).

The conceptual arguments for the impact of organizational learning on an organization’s performance (e.g. airline performance) sound rather convincing; however, the important impact of organizational learning upon an airline’s performance during and after the completion of mergers and acquisitions has received limited attention in the aviation literature. Therefore, this paper aims to address the abovementioned issue by empirically examining whether airlines can improve their performance in controlling their operating costs in the context of mergers and acquisitions. A recent study of Gudmundsson et al. (2017) suggests that mergers or acquisitions between airlines in general do not affect the unit costs of merged entity significantly. In this study, our empirical investigation will focus on the Chinese airline industry, which has seen an exhibited extensive level of horizontal merger and acquisition activities between 2001 and 2010. The recent development of the Chinese airline industry (mergers and acquisitions) is discussed in Sections 2 and 3. The Chinese airline industry is tightly regulated by the Civil Aviation Administration of China (CAAC), which has directed the major structural reforms of the Chinese airline industry. One of the key reforms was the CAAC initiated the airline consolidation policy of airline mergers and acquisitions in 2001/02 and 2010. The landscape of the Chinese airline industry has substantially been changed after the CAAC’s initiatives. With this, this study will also review whether the airline consolidation policy initiated by the CAAC has improved the organizational learning and the performance of Chinese airlines after airline mergers or acquisitions in controlling their operating costs.

The format of this paper is structured as follows. Section 2 provides an overview of recent development (mergers and acquisitions) of the Chinese airline industry and Section 3 describes the key variables for analysis. Section 4 describes the methodology used to investigate the impact of organizational learning on the operating performance of Chinese airlines during and after mergers and acquisitions. Section 5 discusses the empirical results of the study. Section 6 summarizes the key findings and discusses the implications of this study.

2. Recent development of the Chinese airline industry

This section presents a brief account of the recent development of the Chinese airline industry. Many prior studies (e.g. Chow, 2010; Chung, 2003; Dougan, 2002; Zhang, 1998; Zhang and Round, 2008, 2009) offered detailed discussion of the development of Chinese civil aviation sector. In general, the development of the Chinese airline industry can be separated into five stages: (1) full centralization and monopolization prior to 1980; (2) limited liberalization and autonomy (1980–1986); (3) separation of control and full corporatization (1987–1995); (4) market liberalization, decontrolling prices, and ownership reform (1996–2001); and (5) restructuring of state-controlled airlines and entries of non-state-owned airlines (2002 until now). In particular, the study of Zhang and Round (2008) provided robust review of the development from Stages 1–4 and some crucial development at Stage 5. Note that most discussion in this paper will focus on the development of the Chinese airline industry at Stage 5.

After the US 9/11 terrorist attacks in 2001, the global airline industry operated with the challenging environment and nearly all commercial airlines suffered significant declines in revenues and outputs in the subsequent years. In light of this battle, in 2002, the CAAC decided to consolidate the six major state-owned airlines into the ‘Big Three’ airline groups: Air China Group (Air China, China Southwest, and CNAC); China Eastern Group (China Eastern Airlines, China Northwest, China Yunnan, and Wuhuan Airlines); and China Southern Group (China Southern Airlines, China Northern and China Xinjiang). All the consolidation (mergers and acquisitions) among the big three airline groups were completed in October 2002. In fact, CAAC’s planned airline consolidation did not increase the market power of the big three airline groups. Zhang and Round (2009) found that there is no significant airfare increases are seen although the number of airline companies are significantly reduced in the Chinese market after this phase of airline consolidation.

A key development in the Chinese airline industry was that the CAAC allowed privately-owned airlines to gain air operator’s certificates to operate in 2004. Prior to 2004, all commercial airlines in China were basically owned or controlled by the central government or the provincial or municipal governments. This foremost aviation policy shift by the CAAC was prompted by the rapid growth of air travel demand in China and the objective of enhancing the characteristics of social market economy including level playing field, fair competition, fair trade and market driven pricing (Liu and Luk, 2009). Okay Airways was the first private airline received CAAC’s approval to operate in May 2004. Its maiden flight from Tianjin to Changsha Airports occurred in March 2005. Four months later, another two private airlines (United Eagle Airlines and Spring Airlines - the first Chinese low-cost carrier) also gained approvals from the CAAC to offer flight services. Furthermore, Shenzhen Airlines was privatized in May 2005. Two private business groups, Shenzhen Huirun Group and Yiyang Group, paid a total of 2.72 billion yuan to acquire 65% of the ownership of Shenzhen Airlines from its state-owned parent. It should be noted that there was a wave of new start-up privately-owned airlines entering the Chinese aviation market between 2004 and 2007. Among all new start-up airlines, Hainan Airlines Group established three subsidiaries (i.e. Deer Jet (renamed as Capital Airlines in 2010), West Air, and Yunnan Lucky Airlines), whereas the big three airlines did not actively set up their offspring or associates to compete in the Chinese aviation market. Thus, the competition in China’s airline industry became much keener than before. Starting from July 2007, the CAAC stopped the acceptance of new airline application for a period of almost six years, considering the rapid growth of new airline numbers in the Chinese airline industry could affect its competitive environment, flight safety, and service quality (CAAC, 2007).

In addition, Chinese airlines encountered challenging business conditions and declining air traffic demand during the global financial crisis starting in late 2008. For example, Air China and China Eastern Airlines made the record-breaking losses in 2009 and

Apart from airline ownership and management controlled by the state government, air traffic management in China is also tightly controlled by the state government. In present, the Chinese Air Force, not the CAAC, manages and control the national air traffic system.
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