Case for Discussion: "US Air For Sale"[1]

Background: On October 2, 1995, USAir, at the time the nation's fifth largest airline, announced that it had approached United Airlines and American Airlines about a possible buyout. United and American are the two largest U.S. airlines, and both are interested in growth in the highly competitive airline market. United and American must now consider what to do.

Financial Projections: Financial analysts for both United and American have made projections for all the possible scenarios, on the request of the strategic bidding consultants. They say that United and American start in equally strong positions, but that can change depending on who wins the auction.

The three possible outcomes for an airline are:

Neither firm bids enough for US Air to accept. Both United and American will maintain their strong positions, and they can expect future profits of $50 billion each.

Our airline wins. The winning airline will become the dominant firm in the market, and can expect future profits of $80 billion. The purchase cost of US Air, however, must be subtracted from this in order to calculate net profit. Therefore, the payoff for the firm with the winning bid can be written as

$$Payoff_{Winner} = 80 - B_{winning}.$$

It is estimated that the minimum price US Air will accept is $10 billion.

Our airline loses. The losing firm may have trouble competing with the larger network of the winner because of the greater variety of flights a large airline can offer. The more, however, that the winner pays for US Air, the better off is the loser, because the cash flow the winner uses to pay for the acquisition is no longer available for other investments in new equipment

[1] This case was developed by John Maxwell for G570 at Indiana University, following a suggestion of Patrick Meister and Kyle Anderson, and has been rewritten in the present form by Eric Rasmusen. Date: January 10, 2002. I have teaching notes separately (contact me at erasmuse@indiana.edu).

and lenders will be more reluctant to lend to the newly enlarged firm. The analysts suggest that a good approximation to the payoff of the losing firm will be

$$Payoff_{Loser} = 30 + .25 * B_{winning}.$$

In particular, if the winner pays just \$10 billion for US Air, the loser's profit will be \$32.5 billion.

Auction Rules: It is unclear which of two methods of offering themselves for sale US Air will follow. It is thought that an English auction and a sealed-bid auction are the leading candidates.

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Your Position: You have just been appointed to the board of directors for either United Airlines or American Airlines. It is your duty to decide whether you want to place a bid for US Air, and what amount you will bid if you do. Note that if a majority of the board of directors cannot agree on a bid, no bid at all will be made.

English Auction Rules: US Air will solicit initial bids in writing from anyone who cares to bid. Once both bids are received, they will be announced publicly. If there are no bids of at least 10 billion dollars, US Air will continue as an independent firm. If there is at least one bid of 10 billion dollars or above, US Air will allow a counteroffer, and an English auction commences. The winner has purchased US Air.

Sealed Bid Auction Rules: US Air will solicit bids in writing from anyone who cares to bid. Once both bids are received, they will be announced publicly. If there is just one bid, it wins if it is \$10 billion or above. If there are no bids, US Air will continue as an independent firm. If there are two bids, and at least one is \$10 billion or above, the winner has purchased US Air, ties being broken by the flip of a coin.