New Market Structure Realities

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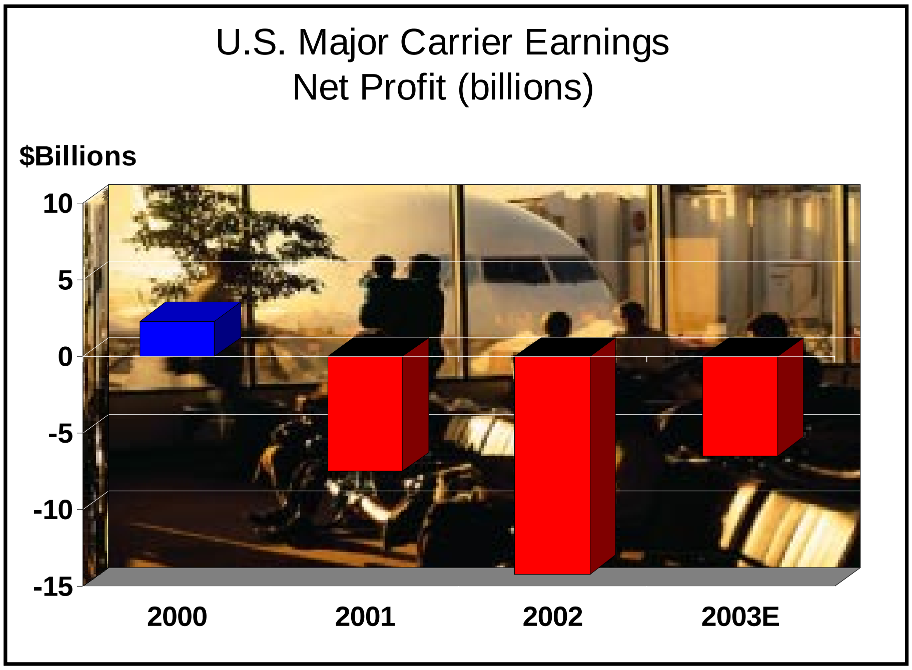
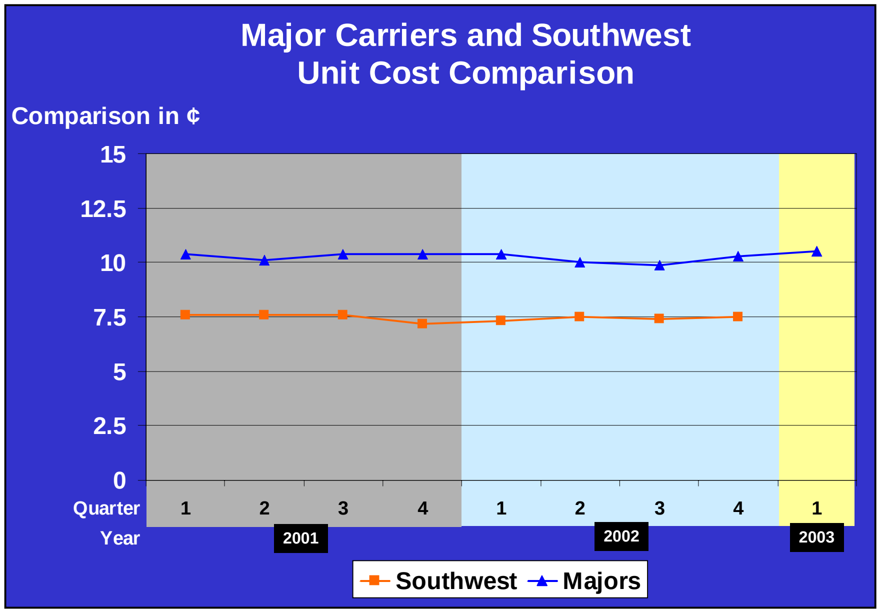
The airline industry during the past two years has been a financial disaster. The major carriers, representing 90% of the industry, have lost almost $20 billion between 2001 and the first quarter of 2003. This loss would have been close to $25 billion, had it not been for the $5 billion 9/11 compensation package provided to the carriers by the federal government. In addition, the major network carriers' balance sheet leverage has become entirely untenable. Fully 95% of the nations airlines' assets are funded by debt.



The question before the house is, "Will this financial firestorm bring down the industry, or will it produce permanent structural changes, to the benefit of airlines, stockholders, and consumers?"

The focus of the industry "fix" tends, appropriately, to be in a few critical areas. First, costs must be reduced across the board in response to long-term changes occurring on the pricing side of the revenue equation. Second, the major carrier hubs and fleet mixes are being adjusted to not only optimize hub synergies, but to create networks that will at least in part allow the higher cost network carriers to avoid having all of their major markets in competition with the increasingly powerful low-fare carriers. For example, the US Airways that emerged from bankruptcy will expand its use of RJ aircraft from its hubs and increase its U.S. to Europe and Caribbean market penetration as vehicles for avoiding head-to-head competition with Southwest, AirTran, and jetBlue. Beyond the basic attack on costs and network restructuring, there is a vast opportunity to improve customer service while at the same time enhancing manpower productivity and lowering costs even further through the use of technology. Technology enhancement is evident on the cost as well as the revenue and travel distribution side of the equation. While the cost, network, and technology fixes are essential to the survival of the network carriers, the driver is revenue. The network carrier segment of the airline industry is suffering from excess capacity, low-fare carrier growth, and the unwillingness of the business traveler to pay a significant premium for the benefits offered by the network carriers. In essence, network carrier costs (and this means unit costs of production) must be driven down by about 25%. Since labor generally comprises 40% of a network carrier's cost structure, it has been the focus of intense scrutiny.

As demonstrated in the chart below, Southwest (much like other low-fare carriers) has maintained its unit cost structure relatively unchanged at around 7.5 cents per available seat mile. This has been a function of both cost control, innovation, and a lengthening of its average aircraft stage length. The major network carriers have costs per seat mile in the range of 10.5-11.0 cents per available seat mile, and measurably higher on shorter routes where they compete with Southwest. Thus, competitively, the major network carriers operate at close to a 40% cost disadvantage compared to the low cost-low fare carriers. What is equally if not more significant is the fact that these low-fare carriers, collectively, now account for 25% of domestic passenger traffic.



The more recent changes to the revenue equation are driving the cost and network restructuring.

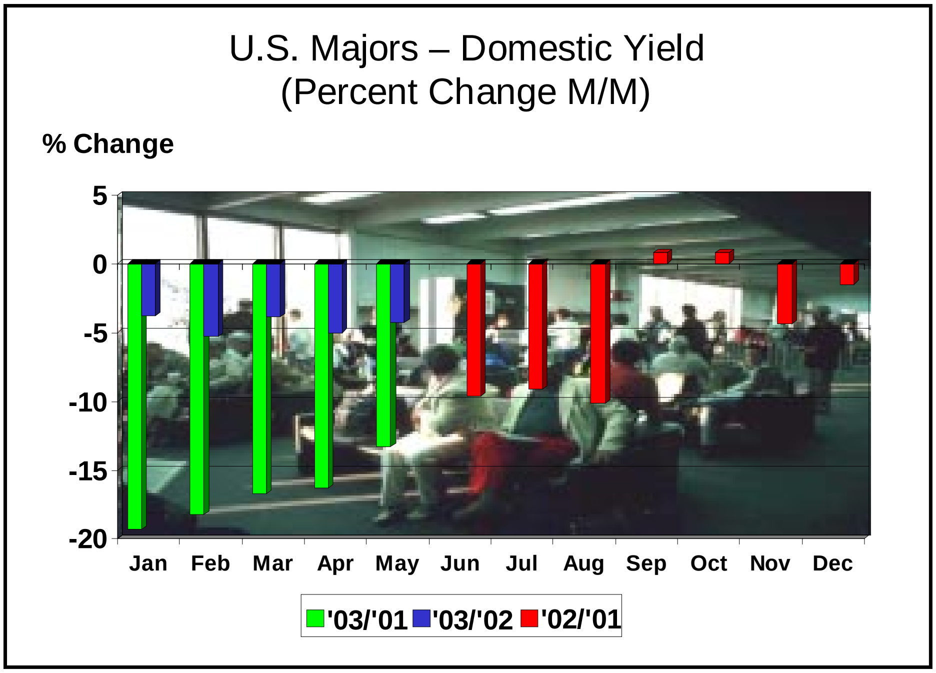
THE U.S. MAJOR CARRIERS ARE EXPERIENCING A SERIOUS REVENUE PROBLEM

Between the first quarter of 2001 and 2003, passenger revenue for the major carriers dropped by 26.8%, and 16% of this drop was yield (or average ticket price) deterioration.

Traffic was down by roughly 13%. While traffic is now leveling off and probably will grow slightly for the remainder of the year, there is little optimism relative to yield.

The yield deterioration situation began to develop in early 2001 and, although it was exacerbated by 9/11, it was not caused by 9/11. Equally important, yield improvements fall almost entirely to the bottom line of the airline, while traffic growth has to be accommodated and there are passenger related costs involved.

As the chart below demonstrates, the decline in yield has been precipitous. This can be attributed to the soft economy, 9/11, the Internet, and excess capacity in the marketplace. There are just too few people chasing too many seats.



The Internet has been a major factor over the past few years. Supplier sites such as jetBlue and Southwest are reporting upward of 70% of all of their bookings taking place on their own sites. The major network carriers are generally only booking 10-15% on their sites, but most have undertaken aggressive programs to move their brand loyal passengers to their own websites. Consequently, they are significantly increasing bookings on their sites, year to year. The third party travel websites such as Orbitz, Travelocity, Expedia, and opaque sites such as Hotwire and Priceline.com have also become a major factor. These third party sites offer the consumer a vast array of travel opportunities, generally at the lowest possibly prices. The consumer, business and leisure, now have third party and supplier direct vehicles for finding the best price-quality options to meet their needs.

The low-fare carriers have taken advantage of the situation by growing their capacity while the major network carriers have had to severely restrict capacity.

THE GROWTH OF THE LOW-FARE CARRIERS

For the sake of simplicity, we will define the low-fare carriers as Southwest (WN), jetBlue (B6) ATA (TZ), AirTran (FL), America West (HP), Frontier (F9), and Spirit (NK). Since 1990, these carriers have grown from representing about 8% of the U.S. market to now representing over 26% of passengers carried. Today, Southwest is almost 2/3rds of the 26%, but jetBlue is growing at a rate of 40% per annum, and with its recent order for 90 seat RJ's, will become a major factor as well. This low-fare carrier group typically grows at a rate of 10%-20% or more per annum, while the U.S. domestic industry traffic grows at only about 3% per annum. Thus, while some low-fare carriers will have to moderate their growth rates, they will likely represent over 35% of passengers carried by the U.S. industry by 2010…or sooner.

A number of these low-fare carriers, most notably Southwest, AirTran, and jetBlue have strong balance sheets, modern fleets, and thus the flexibility to continue pressuring the market and the major network carriers.

Since the average unit cost of the low-fare carriers is only a little over 7 cents per seat mile, compared to over 11 cents for the major network carriers, their growth will continue to pressure the large network carriers. These low-fare carriers can impact the network carriers very substantially when they are a large enough factor in any city-pair market to, in effect, create the benchmark price. Once the benchmark is established, with adequate capacity, the major network carrier must try to extract a premium to the benchmark by selling comfort, amenities, and frequent flyer benefits. Obviously, these enhancements go only so far.

As an example, United's full fare economy mid-week price between Washington/Dulles and San Francisco is $2,453, while jetBlue offers Washington/Dulles to Oakland on the same Airbus 320 at only $453, and Frontier has one-stop over Denver for $500. Are your frequent flyer miles worth $2,000?

A MICROCOSM—AMERICAN AIRLINES

American is an ideal proxy for the nature and scope of the challenge. It has generated negative operating profit margins the past two years of roughly 20%. Thus, even if it substantially reduces its labor and selected other costs, it cannot generate adequate profits without a substantial recovery on the revenue side. The question is, then, how does it manage the yield and revenue per departure upward.

We examined American's largest fifty domestic markets (by passengers for the year ended June 2002) that produce close to 25% of its domestic revenue. These fifty markets exhibit a number of characteristics:

1. American is the largest carrier in only 33 of its top 50 markets.
2. Within the 33 markets where it is dominant, AA often cannot extract much of a premium.
3. There is measurable low-fare competition in 40 (inclusive of secondary airports, e.g. DFW/DAL) of the top 50 markets.
4. In 34 of its top 50, it faces serious competition from either Delta, Continental, or United.
5. American's yield, adjusted for length of haul, are generally lower in markets where there is low-fare carrier competition. For example, American's yield in the Chicago-Miami market is 13.56 cents, only 5% higher than the industry average of 12.90 cents. This relatively low yield is, in some respects, driven by Southwest's seven frequencies each day between Chicago-Midway and Fort Lauderdale.

THE OUTLOOK

In view of the market circumstances, it is clear that a modest economic recovery will, in conjunction with severe cost cutting, reduced capacity, and improved productivity, allow most of the major network carriers to survive. On the other hand, their growth will be impeded compared to that of the low-fare group because they are increasingly finding that they must compete in major city-pair markets with the low fare carrier(s). They can (and some do) optimize their hubs and partially avoid competing with the low-fare carriers by utilizing more RJ's to feed smaller hubs from more modest sized cities that the larger low fare carriers may choose not to serve. An example of "hub sizing" using RJ's is Cincinnati, where Delta now operates 75% of its departures with the RJ fleet. Second, they can move more capacity into international markets from their hubs, often in joint venture with alliance partners. This allows them to further avoid low-fare competition. Finally, they can utilize larger aircraft in the hub-to-hub and major city-pair markets from their hubs to lower unit costs to levels that will be competitive with the low-fare carriers' generally smaller (higher unit cost) aircraft. And, they will be able to extract some fare premiums, although it is not clear how substantial those premiums will be. In this manner, they will likely be able to compete over the long run, but it will be at reduced domestic market shares.

<u>What, then, is the new reality?</u> It is that the consumer will have increasing price and quality options and channels in which to shop for their preferred price-quality combination. The leisure traveler is almost totally price driven, and now the businessman has made it clear that he or she won't pay a large premium for a modest service differential. Thus, the large network carriers must substantially restructure their networks, reduce unit costs, maximize the utilization of technology, and leverage whatever fare premium they can achieve based on service quality and frequent flyer-driven brand loyalty.

Last, and equally important, balance sheets must be restored to reasonable industry standard in order to ensure survival during the next recession. Surely it will happen, and when it does, Congress may be far less sympathetic than it was post-9/11.