

It has taken six years for US major airlines to return to profitability. While they have made significant reductions in their costs they have weakened their balance sheets and continue to face threats. Are the US majors now profitable enough to survive in the long-term?

Which direction are US Airlines heading?

US airlines have received more than their fair share of attention over the past six years. Five out of six US majors have restructured since 2001, with Continental Airlines the only one not to have instigated a major reorganisation. In 2006, the US industry returned to profitability for the first time since 2000, reporting an operating margin of 5%. Have the airlines reorganised themselves sufficiently to remain profitable, or are they still vulnerable?

Pre-9/11 situation

The US airlines had high operating margins up until the summer of 2001. Taking into account all airlines with annual revenues higher than \$100 million, US carriers recovered from their losses of the early 1990s to operating incomes of \$5.9 billion in 1995. Performance climbed to peaks of \$9.3 billion in 1998 and \$8.4 billion in 1999, equal to operating margins of 7.8% and 9.1%. These high margins and revenues of the late 1990s were mainly due to low fuel prices, unprecedented load factors of 70-71%, and high passenger yields as a result of the US stock market boom.

Yields peaked in 2000 at 13.41 cents, followed by airlines increasing their capacities of available seat-miles (ASMs) at higher rates than previous years. The US stock market declined in late 2000, and average industry passenger yield for 2001 was almost a cent down on 2000. This statistic is skewed, however, since it includes four months of operations after the 9/11 terrorist attacks. Yields were still strong enough to generate good operating margins up to 9/11.

The fundamentals of the US airlines at first look good up to September 2001. A

closer analysis, however, reveals that costs had risen at a faster rate than revenues during 1999 and 2000. It was during this period that airline managements were agreeing substantial increases in salary scales to employee unions, particularly pilots. Some airlines even advertised the fact that they had some of the highest-paid pilots in the industry.

Unit costs for the nine largest US airlines breached the 10.0 cent per ASM barrier in 1996, and exceeded 11.0 cents in 2000. Costs increased by another 8% to 11.89 cents in 2001, although this statistic is also skewed, since airlines needed some time to reduce their absolute dollar costs in line with the massive reduction in ASMs they implemented after the shock of 9/11. The overall picture is that unit costs had been rising faster than unit revenues up to 9/11, and so the profitability gap was narrowing.

Jet fuel was still cheap up to 1999, averaging 53 cents per US Gallon (USG), but then jumped to 81 cents in 2000. The industry's then annual consumption of 16 billion USG meant that its annual fuel bill rose from \$8.5 billion in 1999 to \$12.9 billion in 2000. This increase of \$4.4 billion compares with the industry's operating profits of \$8.4 billion in 1999 and \$7.0 billion in 2000.

9/11 and the aftershock

The immediate effect of the 9/11 terrorist attacks was for airline traffic, measured in revenue passenger miles (RPMs), to dive. US airlines had to reduce capacity to keep load factors high in an effort to force passenger yields to recover.

Airlines could only then add capacity back and rebuild their operations as passenger numbers increased.

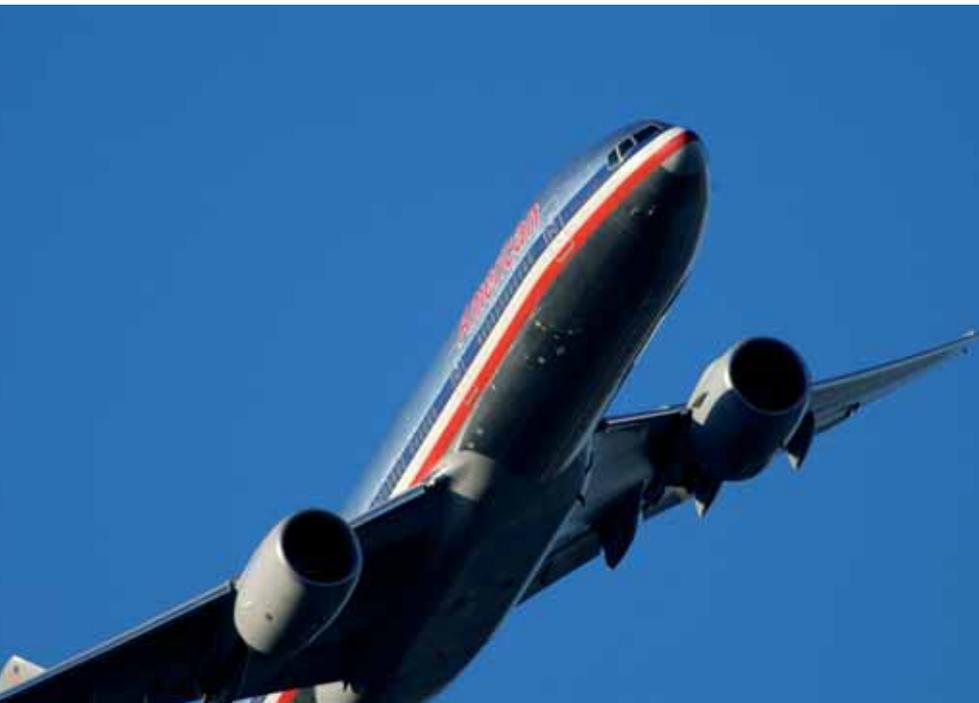
The speed at which traffic would return was unclear, but it soon emerged that passenger traffic could be stimulated to return through low fares. The low-cost carriers (LCCs) took advantage of this.

JetBlue was a fledgling carrier at this stage, having started operations in February 2000, but Southwest already had a large operation. Although its RPMs for September 2001 were down by 21.6% on 2000, the majors suffered still greater drops in RPMs of 19-33%. Southwest recovered fast, with its October 2001 traffic being just 1% lower than the year before. It responded to the industry-wide drop in traffic after 9/11 by adding capacity while the majors reduced theirs. Southwest stimulated traffic to fill this capacity by lowering fares, and so took market share from the major airlines. As a result, Southwest generated 5.5% more ASMs in 2002 than it did in 2001.

This compares to most majors which reduced their 2002 levels by 5-10% compared to 2001. The exception was AMR Corporation, which provided 12.5% more ASMs in 2002, but this was followed by an operating loss of \$3.3 billion for the year.

JetBlue, although small, almost doubled the size of its operation in 2002 over 2001, while AirTran increased its operation by 26%. The capacity added by the LCCs exacerbated the majors' problems, and caused the problem of over-capacity in the overall US market. The LCCs continued to operate profitably. The problem of over-supply weakened yields and revenues.

Continental had the strongest operating profit of all majors in the initial period after 9/11, making an operating loss of \$312 million in 2002 compared to American's loss of \$3.3 billion and



United's loss of \$2.7 billion. Southwest was the only one of the US's nine largest airlines to report operating profits from 2002 to 2005, reporting \$418 million (a margin of 7.6%) in 2002.

2002 to 2004

The majors' initial strategy of cutting back ASM capacity was not enough to return them to profitability. While USAirways was restructuring under Chapter 11 for the first time during 2002, all other airlines in the US appeared to be waiting for the problem of over-capacity to be solved by one large carrier going into liquidation. Chapter 11 prevented this from happening.

Continental's position was relatively strong in 2002-2004, with it having the lowest unit cost per ASM of all six US majors. Other carriers needed to take action to make far-reaching reductions in their unit costs and strengthen passenger yields and revenues.

American, for example, had unit costs of 11.14 cents in 2002, which it reduced to 9.72 cents in 2004. It managed to reduce its non-fuel costs by \$3.4 billion over this period, from \$18.2 billion in 2002 to \$14.8 billion by 2004, while maintaining the size of its operation and generating a similar number of ASMs. About half this \$3.4 billion reduction came from labour costs, which fell by \$1.7 billion. This was offset by the rise in fuel prices, which were 76 cents per USG in 2002 and averaged 121 cents in 2004. Although this increased American's annual fuel bill by \$1.4 billion, the airline nevertheless managed to reduce its annual costs by almost \$2 billion.

Other majors did not make the reductions necessary to avoid incurring

larger losses in later years. Delta, for example, saw its non-fuel costs rise by \$2.5 billion from 2002 to 2004. Its fuel prices rose by 50 cents per USG to 116 cents, thereby raising Delta's annual fuel cost by \$1.2 billion.

Delta kept capacity in line with traffic during 2002-2004. Like other majors, Delta managed to prevent yields from slipping, although at 12.73 cents per ASM they were 1.0 cent lower than 2000 levels. Delta managed to increase load factor by more than two percentage points, and unit revenues by 0.5 cents per ASM. Absolute revenue climbed by \$1.7 billion. Delta could not escape increasing costs, however, and its absolute costs rose from \$14.6 billion in 2002 to \$18.3 billion in 2004. Its non-fuel costs increased by \$2.5 billion, although this was little to do with labour. Fuel costs climbed by \$1.2 billion.

Understandably, Delta made an operating loss of \$1.3 billion in 2002, 9.8% of revenue. Losses narrowed in 2003, but its sharp rise in costs during 2004 increased its losses again to \$3.3 billion; one of the worst results reported by a major during the post-9/11 period.

Overall industry performance during this period was poor, with the US's nine largest airlines reporting a combined operating loss of \$9.3 billion in 2002, \$2.8 billion in 2003 and \$4.8 billion in 2004 (see table, page 38).

While American restructured, United entered Chapter 11 in late 2002, where it remained for about three years until late 2005. United's early entry into Chapter 11 allowed it to reduce costs and losses.

American and United were the two worst performers of 2002, making the largest losses of \$3.3 billion and \$2.7 billion. Delta and United were the two

AMR Corporation made an operating profit of \$1.06 billion in 2006, the largest of all US majors. It was also one of the first majors to improve its financial performance. Despite this, it has one of the weakest balance sheets of US major airlines.

worst performers in 2004. Delta's losses increased from \$1.3 billion in 2002 to \$3.3 billion in 2004. United had managed to reduce its annual loss to \$854 million. American's losses had shrunk further to \$144 million in 2004. All other majors had reduced their losses by 2004.

LCCs, however, continued to add capacity and penetrate more markets, and so limited the majors' strategy of removing capacity in an attempt to hold up yields.

The second whammy

The most noticeable feature of 2002-2004 was that Delta and Northwest failed to cut their costs. Delta's unit cost increased slightly to 10.2 cents per ASM, Northwest's unit costs increased by 0.8 cents to 10.3 cents per ASM.

While airlines were still grappling with the over-capacity problems caused by the 9/11 attacks, the price of oil and consequent price of jet fuel started to rise during 2004. A guide to how the price of crude oil relates to the cost of fuel is to add \$15-20 per barrel for refining, and then divide the total by 42USG to derive the cost per USG for jet fuel. An oil price of \$50 per barrel therefore results in a jet fuel price of \$1.55 per USG. Current oil prices of \$72 per barrel take jet fuel up to \$2.2 per USG.

While other majors reorganised, Delta and Northwest were hardest hit in 2004 and 2005 by the rising cost of fuel. The average fuel cost rose from 67 cents in 2002 to 116 cents in 2004. This increased the industry's annual fuel bill by \$8 billion over two years, and Delta's costs by \$1.3 billion. This was compounded by Delta's other rising costs.

Northwest's unit fuel prices were similar, with its annual fuel bill climbing from \$1.4 billion in 2002 to \$2.2 billion in 2004. Its non-fuel costs rose by \$600 million to \$9.6 billion, although none of this was related to labour. Unit costs rose from 9.5 to 10.3 cents over the period.

Hurricane Katrina in July 2005 damaged refining capacity in the Mexican Gulf, combining with other global factors to compound further rises in the price of fuel. Average 'retail' prices paid by airlines leapt from 118-121 cents per USG in 2004 to 170-178 cents in 2005, thereby increasing the industry's annual fuel bill by another \$8.8 billion. AMR Corporation's annual fuel bill, for

TOP US AIRLINES FINANCIAL PERFORMANCE 2000 TO 2007

Airline	2007 1st half	2006	2005	2004	2003	2002	2001	2000
Revenues-\$m								
Alaska Air Group	1,664	3,332	2,975	2,722	2,435	2,219	2,141	2,177
AMR Corp	11,306	22,563	20,712	18,645	17,440	17,420	18,963	19,703
Continental	6,889	13,128	11,208	9,744	8,870	8,401	8,968	9,899
Delta Airlines	9,147	17,171	16,191	15,002	13,303	13,305	13,879	16,742
Northwest Airlines	6,054	12,568	12,286	11,279	9,510	9,489	9,905	11,415
UAL Corporation	9,586	19,340	17,379	16,243	13,724	14,286	16,138	19,352
America West		3,770	3,397	2,482	2,223	2,021	2,035	2,309
USAirways	5,887	8,076	7,212	7,073	6,762	6,915	8,253	9,181
Southwest	4,781	9,086	7,583	6,527	5,936	5,522	5,555	5,650
JetBlue	1,338	2,363	1,701	1,266	998	635	320	105
Total revenues-\$m	56,652	111,397	100,644	90,983	81,201	80,213	86,157	96,533
Operating costs-\$m								
Alaska Air Group	1,604	3,422	2,983	2,801	2,453	2,313	2,263	2,198
AMR Corp	10,591	21,503	20,801	18,789	18,284	20,750	21,412	18,378
Continental	6,562	12,660	11,247	9,973	8,667	8,713	8,825	9,215
Delta Airlines	8,502	17,113	18,192	18,310	14,089	14,614	15,481	15,018
Northwest Airlines	5,496	11,828	13,205	11,784	9,775	10,335	10,773	10,846
UAL Corporation	9,141	18,893	17,598	17,097	15,084	16,973	18,480	18,560
America West		3,805	3,518	2,485	2,199	2,185	2,459	2,322
USAirways	5,482	7,484	7,425	7,421	7,183	7,834	9,435	9,226
Southwest	4,369	8,151	6,858	5,975	5,454	5,104	4,924	4,628
JetBlue	1,278	2,236	1,654	1,153	830	530	285	120
Total operating costs-\$m	53,025	107,105	103,468	95,788	84,017	89,351	94,337	90,511
Operating profit-\$m								
Alaska Air Group	60	-90	-8	-79	-18	-94	-122	-21
AMR Corp	715	1,060	-89	-144	-844	-3,330	-2,449	1,325
Continental	327	468	-39	-229	203	-312	143	684
Delta Airlines	645	58	-2,001	-3,308	-786	-1,309	-1,602	1,724
Northwest Airlines	558	740	-919	-505	-265	-846	-868	569
UAL Corporation	445	447	-219	-854	-1,360	-2,687	-2,342	792
America West		-35	-121	-3	24	-164	-424	-13
USAirways	405	592	-213	-348	-421	-919	-1,182	-45
Southwest	412	935	725	552	482	418	631	1,022
JetBlue	60	127	47	113	169	105	35	-15
Total operating profit-\$m	3,627	4,292	-2,824	-4,805	-2,816	-9,318	-8,180	6,022

example, rose by \$1.6 billion in 2005.

Delta and Northwest had not made any significant reductions in their cost structures and were the worst affected by the continuing rise in fuel costs. Both carriers consequently filed for Chapter 11 bankruptcy protection in September 2005.

Overall industry performance in 2005 was nevertheless an improvement over 2004, with the nine largest carriers generating 8.2% higher revenues with 6.2% higher costs. The operating loss of

\$2.8 billion was an improvement on the \$4.8 billion loss the year before.

Revenues increased by \$10 billion, but costs increased by another \$8 billion, due to a net increase of higher fuel cost over reductions in other costs.

Delta accounted for the largest portion of this loss, contributing \$2.0 billion, although it had improved from 2004. Northwest was the second worst performer with a loss of \$919 million, making it the only major with increased losses. All other majors reported losses,

although these were gradually reducing on an annual basis from 2002.

Southwest

Southwest was the exception among the nine largest US airlines, generating an operating profit of \$725 million in 2005. Its performance had steadily improved since 2002, when it made \$418 million.

As described, Southwest had taken the opportunity to expand its operation fast since 9/11. It increased ASMs by just

4.2% and 5.5% in 2002 and 2003, but accelerated its expansion from 2004.

Southwest managed to achieve high passenger yields, reaching 12.09 cents in 2001, 11.69 cents in 2002 and 11.97 cents in 2003. It also maintained control of its absolute costs, and remained profitable throughout 2001-2006.

Southwest had a main advantage over all other US carriers from 2004, because it signed a large fuel hedging contract, valid until 2010, enabling it to buy fuel at rates that have since proved to be lower than the 'retail' prices other airlines have had to pay. For example, Southwest realised its biggest saving from fuel hedging in 2005, when it paid an average price of 103 cents per USG, compared to the 169-178 cents that other airlines were paying. This saved Southwest \$930 million in 2005, compared to its operating profit of \$725 million. It would clearly have had to adopt an alternative strategy had it not concluded its fuel hedging contract the year before.

The savings from fuel hedging have given Southwest the ability to expand quickly. It would have been forced to maintain a tighter control on its capacity to keep unit revenues well above higher unit costs had it not hedged fuel. Fuel hedging has therefore allowed Southwest to add capacity and penetrate more markets at the expense of other carriers.

While it did not benefit from hedged fuel, jetBlue, which had grown from a revenue of \$635 million in 2002 to \$1.7 billion in 2005, also had an advantage of low unit costs. Vaughn Cordle, chief executive officer at Airline Forecasts explains that this is because jetBlue was expanding fast, had no 12-year employees at the highest salary scales, and its young fleet was enjoying maintenance honeymoons. JetBlue was therefore able to penetrate many markets and compete aggressively on yields.

Restructuring programmes

In summary, the strategy followed by major airlines over the past five years has been to reduce domestic capacity and allow traffic growth to increase load factors, thereby forcing up passenger yields and increasing revenues. The improvements in yields have been curtailed, however, by the increased presence of LCCs. In parallel with this, the airlines have sought to reduce non-fuel costs where possible. The main reduction in costs has been with labour. These two achievements have been offset, however, by higher fuel prices.

The continued problems have seen five major carriers go through restructuring programmes from 2002 to 2006. American is the only carrier not to have entered Chapter 11, although it did restructure its costs. Continental is the

DELTA & AMERICAN AIRLINES RESTRUCTURING PROGRAMMES

Delta Airlines

Delta allowed its operation to peak in 2005, and has since reduced it again. Its operation and total ASMs increased by 10.6% over three years to 2005. This was accompanied by a sharp rise in all costs, and non-fuel costs rose in proportion to the size of the operation. As with other carriers, fuel expenditure was 2.5 times higher in 2006 than 2002, so overall costs climbed by 25%.

Delta implemented a three-point restructuring plan in 2005. The first point was to improve revenues by \$1.1 billion. The second and third points were to make savings from two main areas: Chapter 11 restructuring and savings in employee and labour costs.

"We took advantage of our fleet structure, and re-deployed some aircraft from US domestic services to international routes that deliver higher passenger yields. We have increased our international routes from 60 to 109, and have added services mainly to European and Middle Eastern cities. We have also added a few new services to Africa and Latin America, however, and a couple of trans-Pacific routes," explains Loren Neuenschwander, managing director of corporate restructuring at Delta.

"We have used Chapter 11 to phase out the MD-11 fleet and have closed our Dallas-Forth Worth hub operation, and we have seen cost reductions in relation to operating fewer services," continues Neuenschwander. "We also aimed to make a \$930 million saving from labour and employee-related costs. The plan has been to reduce our employee numbers by 6,000, and renegotiate salary contracts with our remaining employees. A main contributor to this was the agreement we reached with our pilot union to lower salaries and improve productivity. This is in place until 2010."

Put into perspective, Delta's operation in 2006 was only 4.4% larger than in 2002. Its non-fuel costs for the two years were almost identical, but its fuel expenditure was \$2.6 billion higher and total costs 17% higher, illustrating the effects of high fuel prices.

Delta did, however, manage to increase revenues, which were \$980 million higher in 2006 compared to 2002. The reduction in capacity saw load factors improve by another two percentage points to 78.5% and yields strengthened as a result to 13.46 cents, almost reaching 2000 levels.

While capacity was only 4.4% more than 2002, traffic in 2006 was 13.8% higher and revenues 29% higher because of higher load factors. Delta produced an operating profit of \$58 million in 2006, and continued to improve its position in 2007. Although fuel prices have continued to rise, Delta kept control of its unit costs and revenues in the first six months of 2007. It reported an operating profit of \$645 million, a margin of 7.1%.

American Airlines

American has made the most progress in reducing its costs in real terms compared to the size of its operation. AMR Corporation increased its ASMs by only 5% from 2002 to 2006, most of this increase occurring with American Eagle.

In contrast, AMR's annual non-fuel costs have reduced by \$3 billion. Labour costs have fallen by \$1.6 billion, but have been offset, however, by a rise of \$3.8 billion in fuel, with costs rising overall by \$753 million, at the same rate as total ASMs. American has managed to prevent any significant rise in its unit costs.

AMR's traffic grew by 18.3% and revenues by 29%. Load factors consequently increased by almost 10 percentage points to 80.1% by 2006, and its 2006 revenues increased by \$5.1 billion to \$22.56 billion. It eventually reported an operating profit of \$1.06 billion in 2006, a margin of 4.7%.

only one not to have restructured its costs.

An example of how two US majors have structured their costs is given (*see box, this page*).

2006 & 2007 performance

The general strategy employed by US majors, of reducing domestic capacity to improve load factors and passenger yields, and reducing non-fuel costs to return to profitability, has worked. All six US majors reported an operating profit in

2006 (*see table, page 38*), for the first time since 2000. Margins varied, but Northwest had the highest at 5.9% and \$740 million. This was a big turnaround for Northwest, which had made an operating loss of \$919 million in 2005.

AMR Corp was the highest in absolute terms at \$1.06 billion; a margin of 4.7%.

Delta had managed to realise its \$3 billion improvement from 2004 to 2006, and made a small operating profit of \$58 million, just 0.3% of revenue.

United Airlines also crept back to



profitability with an operating profit of \$447 million, a margin of 2.3%.

Continental is the only major to have made profits from 2001 to 2005, and made a respectable performance in 2006 of \$468 million.

Southwest continued to forge ahead, with a profit of \$935 million, an operating margin of 10.3%. JetBlue also reported an improved margin and an operating profit of \$127 million.

The nine largest US airlines had a collective operating profit of \$4.3 billion.

Major airline operating profit performance continued to improve for the first half of 2007, despite further rises in fuel prices. The collective operating margin for the nine largest airlines was about 6%, higher than for the whole of 2006. Northwest continued to improve and made the highest margin at 9.2%, while United doubled its performance to 4.6%. Delta has made the largest gain since 2006, with a margin of 7.1%.

The performance of LCCs varied in 2006 and the first half of 2007.

Southwest has the second strongest margins of the nine largest airlines, still benefiting from its fuel hedging contract.

JetBlue's operating margins have differed little from the majors between 2005 and 2007, with an operating margin of 4.5%. This is explained by its labour costs increasing as employees reach higher-tier salaries and its aircraft require more maintenance.

Future threats

The US airlines have returned to a reasonable level of profitability, but under the prevailing conditions this is unlikely to be enough for them to remain sustainable in the long term. The

continuous rise in fuel costs has offset most of the gains and prolonged the return to profitability, so airlines have drained their cash reserves and increased their debt over a five-year period.

"In 2000, the airlines collectively had \$39 billion of equity out of \$145 billion in assets on their balance sheets, so their equity portion was 21%," explains Cordle. "By 2006 equity had diminished to 6.5% and \$11.5 billion, and the level of debt and liabilities increased to \$166.5 billion. The industry has therefore become over-leveraged, and the airlines need to repay \$33 billion of debt and rebuild their equity. This has to come from retained earnings, but is unlikely to occur before the next industry downturn which is expected in 2012. The US economy is already slowing, however."

While the industry is expected to generate an operating profit of \$6.8 billion in 2007, and airlines to continue to make profits for the next three to four years, absolute profits and profit margins face several challenges. These include the probability of a lower rate of spending on air travel, the possibility of labour costs rising again, further increases in the price of fuel, and continued penetration into more markets by the LCCs that will erode passenger yields.

"The airlines in the US have also had to deal with other issues that have reduced efficiencies," says Cordle. "Air traffic control delays have increased in recent years and it is estimated they now cost the airlines \$7.7 billion a year. Other issues are various passenger taxes.

"The first major issue the airlines have suffered is the reduction in revenue that is estimated to have occurred in recent years," continues Cordle. "Analysis shows that from 1965 to 1996,

Southwest concluded a fuel hedging deal in 2004 that lasts until 2010. This has allowed Southwest to make large savings in its annual fuel costs, with it being as high as \$930 million in 2005.

expenditure on air travel grew faster than personal consumption. The two then grew at similar rates from 1996 to 2000, but expenditure on air travel has grown at a lower rate than total personal consumption for the past six years. Overall, expenditure on air travel has dropped from 1.8% of the US economy to 1.3%; a symptom that the industry is reaching maturity. This reduction means that airline revenues are estimated to be \$27-30 billion less compared to the equivalent level of 10 years ago. The top 34 airlines have an annual revenue of \$100 billion, but this is \$27 billion less than would have been expected."

"The smaller percentage of US GDP being spent on air travel is mainly due to the rise in oil and fuel prices, taking spending power out of the US economy," continues Cordle. "The rise in oil prices has had a double negative effect, since it has added to airlines' costs. The industry's \$14 billion fuel bill in 2000 had increased to \$37 billion by 2006 with fuel prices increasing from 85 to 230 cents per USG.

"The problem is that there is no sign of oil prices abating, and expectations are that prices in the short term could rise from \$70-75 per barrel, but are forecast to average \$70 per barrel to 2012," explains Cordle. Further rises in the cost of oil will trouble airlines already struggling to make reasonable operating margins. An increase of \$10 per barrel is equal to a \$3.8 billion rise in annual fuel cost for the industry, more than half the expected operating margin for 2007.

The reduction in expected revenues and increase in fuel cost explains the enormous pressure put on airlines over the past six years to reduce non-fuel costs. The major target here has been the cost of labour, and the airlines have succeeded. "The major airlines have lost 135,000 employees since 2000, thereby saving \$13 billion a year," says Cordle. "The overall saving in labour is \$15 billion, and comes from a combination of fewer employees, lower salary scales and improved productivity. United, for example, while in Chapter 11, reduced its employees from 95,000 to 52,500, a drop of 45%, and has saved \$3 billion a year in the process. This compares to a capacity reduction of about 20%. The airlines have overall improved employee productivity by 25-30%. The problem is

Delta's restructuring programme has allowed it to improve its overall annual position by more than \$3 billion. The airline had an operating margin on 7% in the first half of 2007.

that this saving in labour costs has been outweighed by higher fuel costs, and the industry cannot repay its debts and add equity back to the balance sheet."

LCCs pose an ever-increasing threat to the majors. Penetration by LCCs into 75% of the US market has driven down yields to 25% lower than 2000 levels in some cases, despite traffic being higher. "The majors' capacity, that is becoming less economic, is basically being displaced by the LCCs. Yields are still under pressure, despite the majors reducing their domestic capacity by 20% since 2000. Despite having the highest labour cost per employee of \$97,000, compared to an average of \$75,000, Southwest still has the advantage of fuel hedges up to 2010, and also has the strongest balance sheet with 46% equity. There are several other LCCs, including some start-ups, which are continuing to increase domestic capacity and are providing it at low unit costs per ASM, so the problem of relatively weak profitability continues."

Future scenarios

The airlines need to meet four demands from their profit margins if they are to remain sustainable, but Cordle warns they are unlikely to meet all of them. "Airlines first need to give their shareholders a reasonable return. They also need to repay \$33 billion in debts and rebuild their balance sheet equity, reinvest in competitive resources, and add back some of the labour costs they have saved through demands from unions. They cannot meet all four of these demands from their current profit levels.

"In terms of reinvestment in resources," continues Cordle, "airlines' capital expenditure is only 50% of depreciation, clearly showing they are behind their fleet and asset renewal programmes. Northwest, for example, may have the best profit margin this year, but it has an old fleet and will later have to invest heavily in aircraft."

There is a real possibility that unions will demand increases in salary scales to previous levels. A 10% increase in American's annual labour cost, for example, would raise costs by \$700 million, about 70% of its 2006 operating profit. "Northwest's unions want \$400 million back in labour costs, which would take a large chunk from its profit



margins, before any other cost increases from oil are considered," says Cordle. "United and Northwest have labour agreements in place until 2010 and 2012, but American's agreement is up for renegotiation in 2008 and Southwest's agreement with its pilots is being negotiated now. If labour costs increase, airline profits will fall, which could cause a 30-40% slide in airline stock prices. This would trigger a series of mergers."

Oil and fuel prices are also likely to increase, and a rise of \$10 or more per barrel will not only increase costs but also impact revenues and, like rising labour costs, would trigger some mergers and consolidation in the industry.

"While cost reductions are hard to achieve when airlines first merge, a merger between Delta and Northwest could result in a synergy benefit of \$2 billion," says Cordle. "Increases in fuel or labour costs would bring about mergers between airlines to reduce capacity and push up yields. One possibility is a further shift in capacity from the major airlines to their regional affiliates. This has already happened in recent years. While labour unions are likely to object to further shifts, regional affiliates have an average labour cost of \$44,000 per employee versus the major airlines' average of about \$75,000. A sharp rise in the price of oil would make such a shift inevitable, however."

Even if oil prices remain at \$70 per barrel, Cordle warns that profit margins will not be enough for airlines to meet all four requirements. "Airlines will be unable to generate enough cashflow to reinvest and provide sufficient returns to their shareholders. Unless oil and fuel prices drop dramatically, airlines will generate enough cash to prevent them going into liquidation, but not enough to

reinvest in assets, provide a return to shareholders and repay debts. They will therefore have to sell assets to allow them to repay debt and rebuild equity. This process could continue and some airlines will find themselves in a downward spiral. Even Southwest and jetBlue are not actually earning their true cost of capital, and so are slowing their annual growth rates to 6-8%. This does not stop new entrants adding capacity, however."

While the current situation makes the outlook for the majors appear bleak, there are indications that some of the pressure they have faced will be alleviated.

First, US majors are able to redeploy their widebody capacity to international routes and benefit from the higher yields these generate. These are markets where they do not face pressure from low-cost operators. Majors are therefore well placed to exploit this potential over the next few years.

Another issue is that the US domestic market is becoming saturated, and there are few new markets for them to penetrate. The majors' passenger yields are also holding up. Meanwhile, the LCCs' unit costs are increasing. Southwest's unit cost has risen by 1.6 cents since 2000, and jetBlue's unit cost per ASM has increased by 1.85 cents.

LCCs are also achieving high passenger yields, and in many respects Southwest does not offer a true low-cost service. Southwest's yields were higher than Continental's and United's in the first half of 2007. Overall, the gap between the majors and LCCs has narrowed. [AC](#)

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