



Aviation après le Déluge

THE AIRLINE Industry has finally emerged from the severe recession caused by the impact of the Covid-19 pandemic. It has taken a long time. Previous severe downturns in traffic — caused respectively by the events of the 1990 Gulf War recession, the terrorist attacks on September 11th 2001, SARS epidemic in 2002, and the 2008 Global Financial Crisis — were relatively short-lived: it only took nine- to eighteen-months for traffic to recover to pre-crisis levels, and not long thereafter for growth to rebound to long term trends. This time it will have been over four years before industry-wide RPKs reach the level achieved in 2019.

IATA in its economic outlook issued for the organisation's annual meeting in June raised its forecasts for profitability. In the depths of the pandemic in 2020 revenues halved. In 2021 and 2022 revenues only reached 61% and 88% respectively of the levels seen in 2019 — in large part helped by an explosion in cargo revenues as airlines capitalised on the use of empty aircraft to carry freight in hand with a squeeze on yields because of lack of belly-hold capacity and logistical problems in maritime freight (see graph below).

By 2024, it expects the industry to achieve revenues 20% above pre-pandemic levels.

At the global level IATA forecasts that the industry may generate operating profit margins around the long term normal of 6% — with revenues in 2024 approaching the iconic US\$1tn mark. Operating profits may reach \$60bn (last achieved in 2015 and 2016) and net profits could touch \$31bn (having lost \$140bn at the operating level in the three years of the crisis, and \$100bn at the net) — see graph on the next page. Not surprisingly 80% of these profits are estimated to be realised by airlines in

North America and Europe (see graph on the following page). But, maybe somewhat surprisingly, even airlines in Africa are expected to make their first ever positive profit contribution.

At a global level, the margins are paltry, and as IATA consistently points out, the industry provides returns on investment well below the cost of capital. However, it is worth pointing out that there are a handful of carriers which generate investment-worthy returns (and more than the total industry profits), but a very long tail of under-performing and loss-

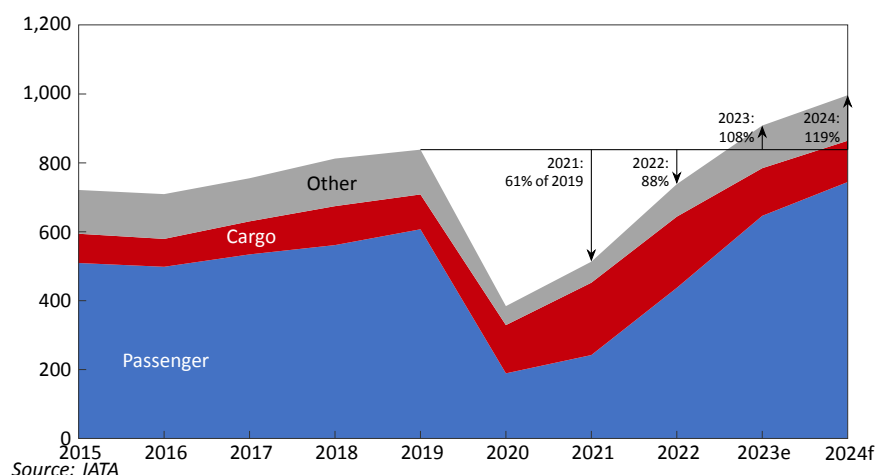
making airlines.

The group's economic presentation, subtitled "Deep Change", focuses on some negatives: climate change, the challenge of rising sea levels, the number of democratic (and some not so democratic) elections in 2024, geopolitical tensions in Ukraine, the Levant and South China

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AIRLINE INDUSTRY REVENUES (US\$bn)



Source: IATA

Aviation Strategy

Aviation Strategy

ISSN 2041-4021 (Online)

This newsletter is published at least six times a year by Aviation Strategy Limited. Our editorial policy is to analyse and cover contemporary aviation issues and airline strategies in a clear, original and objective manner. Aviation Strategy does not shy away from critical analysis, and takes a global perspective — with balanced coverage of the European, American and Asian markets.

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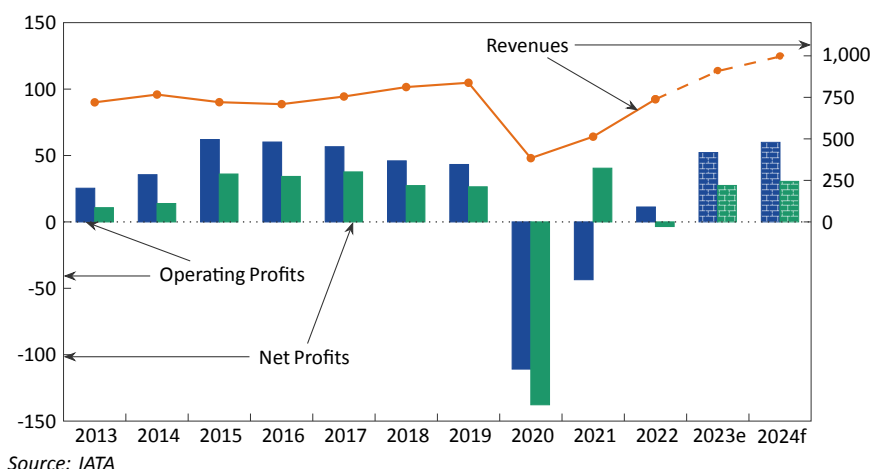
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Aviation Strategy Ltd
Registered No: 8511732 (England)
Registered Office:
6 Langside Avenue
London SW15 5QT
VAT No: GB 162 7100 38
ISSN 2041-4021 (Online)

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AIRLINE INDUSTRY FINANCIAL RESULTS (US\$bn)



Sea, and the unwillingness of the oil and gas industry to invest in the production of sustainable aviation fuel. It also highlights India's achievement of exceeding China's massive 1.4bn population: and India's population will still grow, while China's ages and shrinks.

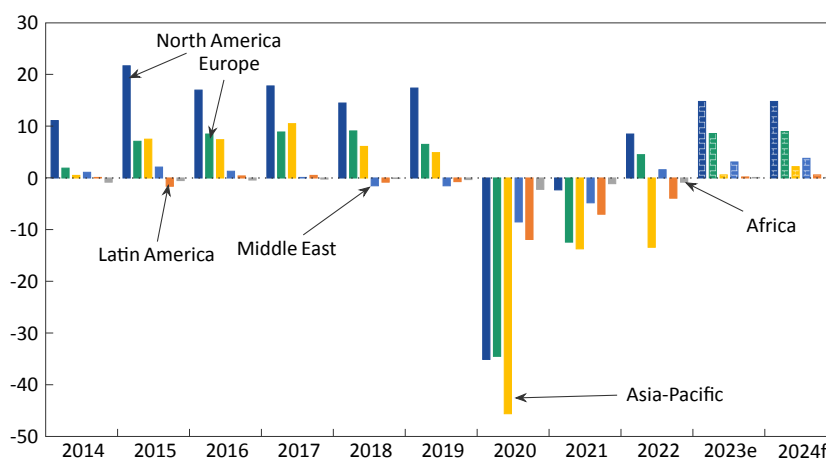
But it does suggest that air traffic will reach an "all time high". Referring to its own (internal?) forecast for long term traffic (supposedly published in Feb 2024), the group expects total industry passenger number to increase by an average 3.8% a year for the next

twenty years. Growth in the relatively mature markets in North America and Europe it estimates at 2.3%-2.7% a year, But the Asia Pacific region is expected to generate a compound annual growth rate of over 5%: by 2043 the region will generate two thirds of the additional 4.1bn passengers expected (there were 4.5bn air passengers in 2019).

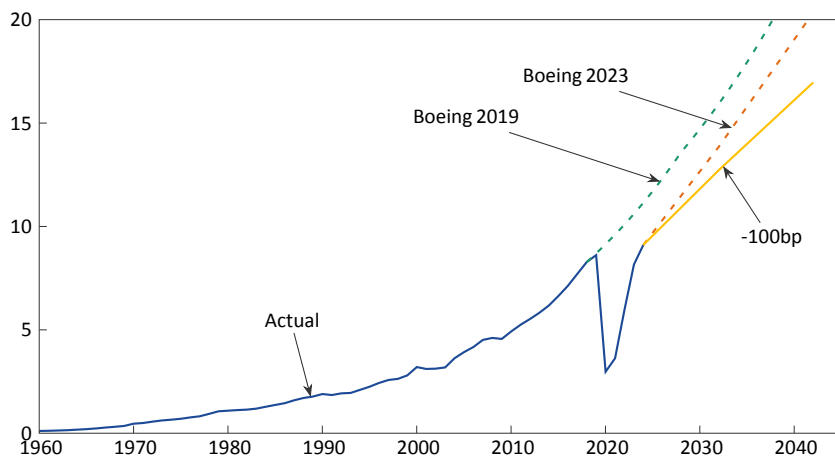
For those of us involved in forecasting, there is only one thing we can be sure of: our forecasts will be wrong.

The traditional view is that traffic

AIRLINE NET PROFITS BY REGION (US\$bn)



AIRLINE INDUSTRY TRAFFIC (RPK tn)



growth in the industry has been generated from a real annual 2% reduction in unit costs arising from technological advances in aircraft and technological design (flying larger aircraft, faster and more efficiently) that translated into a 2% fall in real yields and combined with an average 3% economic growth (as a surrogate for increase in income) to generate a compound average annual increase of 6% in RPK. Traditionally, traffic in RPK is viewed as having grown at twice the rate of GDP. Particularly in the USA, there is a perception that commercial aviation revenues should “rightly” account for 0.8%-1.0% of total GDP. But mere observation is not proof of causality.

The Boeing long term forecasts in their Commercial Market Outlook published in 2019 (see graph above) proposed 20 year growth averaging 4.6% to reach 20tn RPK by 2038. A couple of years later, following the shock of the pandemic, their estimate of growth had fallen below 4% and the 20tn benchmark extended four years to 2042. If the softening of the S-curve is greater by one percentage point over the period, it could be that total demand falls 15% short of

that. Such is the power of compound growth rates.

So to Toulouse — this year’s setting for the annual FEAMA meeting. For those of you who don’t know, this is a symposium (conducted under Chatham House rules — which means we can’t say who said what, or even whether we were there) bringing together the analysts who produce the industry forecasts. Much of the discussion centred round the long term prospect of “market measures” (for which read taxes) that governments might impose to limit demand growth on the path to net zero; and increases in costs (for which read mandated increases in the uptake of sustainable aviation fuel) being a constraint on growth. Notably, consensus numbers suggested another notch down in annual growth forecasts.

In one session, entitled “The View from the Lessors”, and in a presentation delving into geopolitical considerations, we were introduced to a new acronym: the CRINK. Quoting an article by Pulitzer-winning Anne Applebaum, published in *The Atlantic* earlier this year, the speaker highlighted the danger to the world order presented by China, Russia,

Iran and North Korea — all of which are subject to US sanctions and restriction — the billions of dollars they (may) have poured into propaganda designed to undermine western democracy, and their (possible) links with Donald Trump’s MAGA movement.

In addition to neutralising US power, the CRINKs’ goal is to “persuade their own people to stay out of politics, and above all to convince them that there is no democratic alternative: Our state may be corrupt, but everyone else is corrupt too. You may not like our leader, but the others are worse. You may not like our society, but at least we are strong. The democratic world is weak, degenerate, divided, dying.”

Needless to say, the speaker suggested that the second highest risk to the established world order, just behind a disaster scenario for Europe should Ukraine fall, would be Trump winning election for a second Presidential term.

There were a couple of charts in the public presentations which struck us as pertinent.

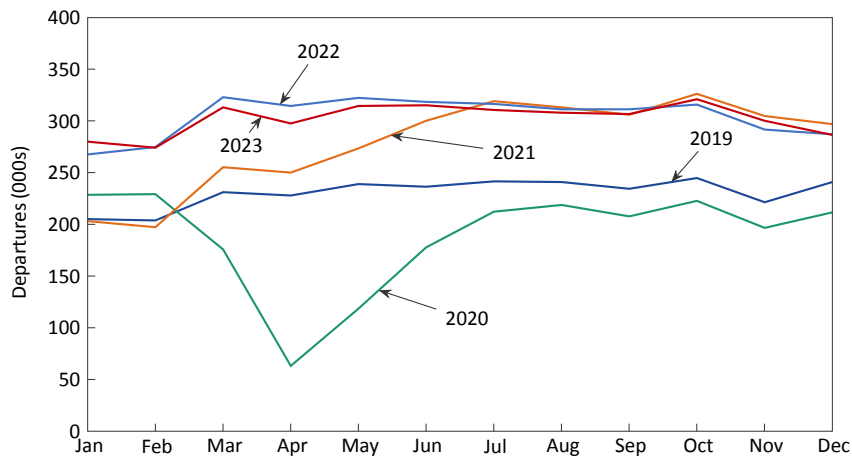
One of the major concerns in the post-pandemic airline era relates to business and corporate traffic. This segment of demand accounts for a minority of total traffic, but a majority of airline income — and has been viewed as particularly important in making long haul operations viable.

A presentation on the performance of business jet operations showed that there has been a meaningful shift in usage since the pandemic (see graph on the following page).

In the depths of the lockdowns in 2020, bizjet usage plummeted (as did all forms of transport). But it recovered quite quickly and from early 2021 there has been a step change: in

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GLOBAL BIZJET FLIGHTS



Source: Wingx Advance GmbH

the past two years the total number of business jet flights has jumped to a level 35% higher than seen in 2019.

The vast majority of business jet usage is in the USA, but there are meaningful levels of operations in Europe, Asia and the Middle East. The authors of the presentation highlighted a retrenchment in regional connectivity in both the US and Europe over the past four years, which may go some way to explaining such a sizeable shift.

In volume terms the data is insignificant. In revenue terms it may be relevant. Whether this trend shows

a desire from rich corporate executives to avoid contamination with the great unwashed on commercial air services, reflects an increasing move to “onshoring” of supplies in markets poorly connected by scheduled services, or is a way of hiding from public scrutiny corporate ESG credentials, who knows?

Maybe this data raises more questions than answers it solves.

Oxford Economics separately presented a slide of air fares in W Europe (sourced presumably from IATA, with whom they have a close relationship) showing a real decline in

fares of 18% between 2010 and 2019 — equivalent to the historic real 2% fall in yields. Their modelling suggests that air fares in Europe will be static in real terms to the end of the current decade, and rise by 40% in nominal terms.

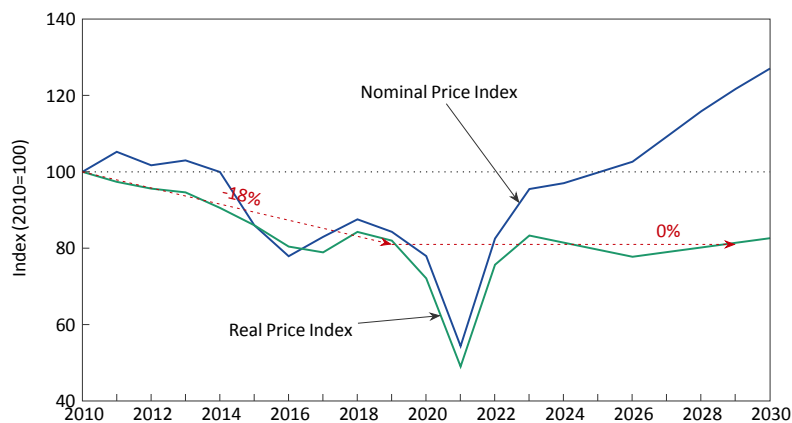
There have been many economic studies performed over the years on price elasticity in air transport as it relates to demand. Intuitively, the lower the price of a commodity or service deemed attractive, the higher the potential for an increase in the willingness to pay for it. So superficially a forecast for stagnant real pricing structures might remove opportunities for demand stimulation and stagnate growth.

The numbers Oxford Economics presented relate specifically to Europe where there are many (specifically European) government imposed directives to force the airline industry to decarbonise — from its ETS, to increased departure taxes, to prescribed mandates on the production of SAF. These costs will be passed on to the consumer — and Lufthansa has recently announced that it will be charging an environmental fee from 2025 of up to €72 per ticket (depending on length of haul) on all flights departing European airports.

But with the constant decline over the years in the real cost of flying, the proportion of a passenger's total trip cost represented by the flight has fallen significantly. Maybe now “price elasticity” also has less of an influence.

In any case, the centre of aviation is moving inexorably eastwards. By 2024, IATA suggests that there will be nearly 10bn passengers a year, and half of them in the Asia Pacific region.

REAL AIR FARES IN WESTERN EUROPE



Source: Oxford Economics, IATA

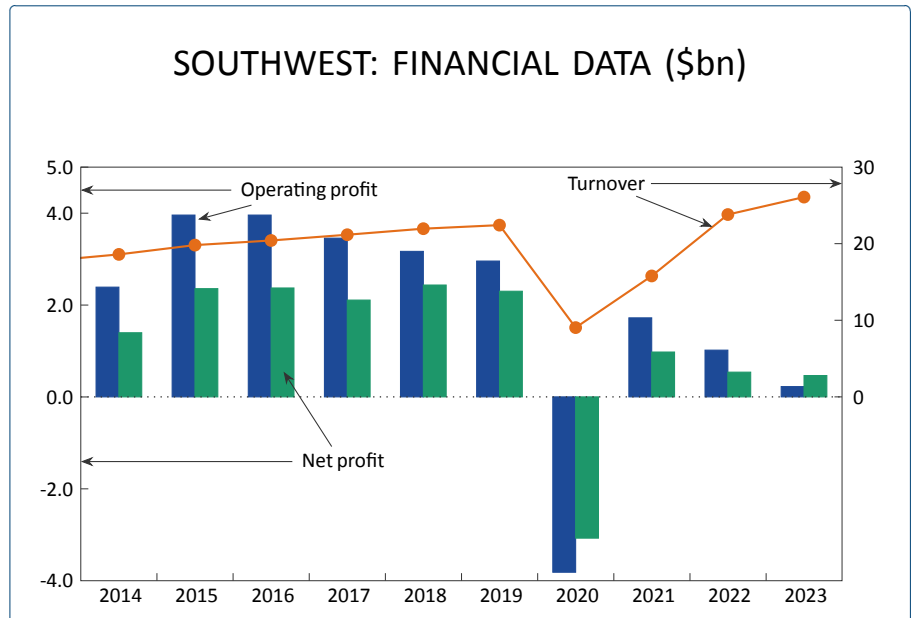
Southwest and Elliott: Brutal Activism

FOR THE CEO of a publicly quoted company, it's an unpleasant experience to find out that an activist investor has taken a substantial stake in your company. When the activist investor turns out to be Paul Singer's Elliott Management, their day is really ruined.

This is what has happened on June 14 to Southwest's CEO, Bob Jordan, who received a letter from Elliott stating that his airline had developed an "insular culture" and delivered "unacceptable financial and operational performance quarter after quarter". Elliott had built up a holding of about \$1.9bn in Southwest, equivalent to 11% of the airline's market capitalisation of just over \$17bn. Elliott claimed in the letter that the share price of a radically reformed Southwest, with a new top management team, would increase by 80% within the next year, bringing the market capitalisation up to about \$31bn.

Elliott's 11% makes it the single biggest shareholder in Southwest, but so far Elliott has received support only from Artisan Partners, owner of about 2% of the stock, out of the other institutional investors (see table right). Interestingly, Berkshire Hathaway owned 14% of Southwest in 2019 before the pandemic made Warren Buffett change his mind again about the investability of US airlines and sell off his stake.

Employees own some 6-7% of Southwest through their long-established ESOP. Elliott has made an attempt to appeal to them, but they will be difficult to persuade given the



contrast in the cultures of Southwest and Elliott.

Who is Elliott?

Founded in 1977 by Paul Singer, a New York lawyer, Elliott has grown into one of the largest activist funds in the world with an estimated \$71bn of assets under management from its

Florida headquarters. It has a well-deserved reputation for ruthlessness, even by the standards of this sector.

The 15-year Argentinian bond saga vividly illustrates the Elliott ethos. Back in 2002 Elliott held Argentinian distressed sovereign debt with a face value of \$630m which it had bought at a deep discount

SOUTHWEST: MAJOR INSTITUTIONAL SHAREHOLDERS PRE-ELLIOTT

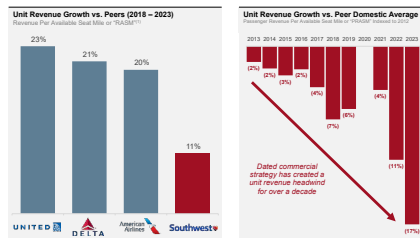
The Vanguard Group	11.0%
Capital Research & Management	10.3%
PRIMECAP Management Co.	8.4%
SSgA Funds Management	6.7%
BlackRock Fund Advisors	4.7%
T. Rowe Price Associates	3.8%
Putnam Investment Management	2.3%
Geode Capital Management	2.2%
T. Rowe Price Investment Management	1.9%
Artisan Partners	1.8%
Total Above	53.0%

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ELLIOTT'S VIEW OF SOUTHWEST'S PROBLEMS

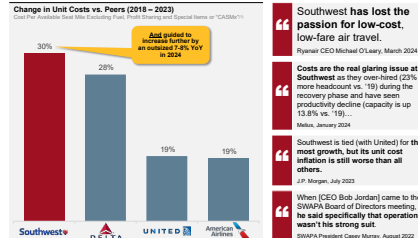
Substantial Revenue Underperformance

Southwest's dated commercial strategy has resulted in the worst unit revenue performance among its peers since 2016



Bottom-tier Unit Cost Performance

Southwest has delivered peer-worst unit cost performance over the past five years. Poor cost control undermines Southwest's competitive positioning as a low-cost carrier



Extraordinary Decline in Southwest's Value

Southwest's enterprise value has declined 44% since 2019, reflecting a substantial diminution in investors' views of Southwest's future earnings power. In contrast, peer enterprise values are only 5% below 2019 levels on average⁽¹⁾



(the price paid has been estimated as just \$117m). Elliott refused the Argentinian government's offer of 30 cents on the dollar and pursued the Argentinian government in courts in the US, Argentina and the UK, attempting to freeze government funds held overseas. Notoriously, it arranged for the seizure of an Argentinian naval sailing ship crewed by cadets in Ghanaian waters. The hapless sailors spent months marooned off the Ghanaian coast until a court liberated the ship. In 2012 Elliott won a New York legal case, with the court ruling that Elliott and others were owed \$1.6bn. Elliott continued to pursue the Argentina government for this sum plus penalties, which caused the Argentinian government international finance markets to seize up.

The bond payment became a major political issue, helping to bring down President Cristina de Kirchner. Her successor Mauricio Macri finally conceded to Elliott in 2017, after 15 years of dispute, paying the investment fund a reported \$2.4bn. Recent Elliott raids have been less dramatic but have involved high-profile names: Samsung, SoftBank, Twitter, AC Milan football club, for instance.

Elliott's criteria

Within the Elliott partnership, portfolio managers have to fulfil three criteria in order to start building a position in a target company:

- ➔ The target company's share price must clearly be undervalued, based on a financial and strategic analysis.
- ➔ There has to be a pathway to

releasing that value — for example, a break-up, a change in operating model, a new management team.

➔ There has to be a strong case, an argument that will convince and bring in other investors and/or industry partners.

Elliott communicates via PowerPoint in the style of McKinsey. It has put together a slick deck titled "Stronger Southwest" (download here) which has a superficially compelling narrative: a once great airline which has completely lost its way, underperformed the rest of the industry and is severely undervalued; the solution is to sack the C-suite and the Board and bring in a new team to implement a new strategy.

Elliott's basic interest is in making a profit through pushing up the

ELLIOTT'S VIEW ON REFORMING SOUTHWEST

Entrenched Views on Strategy

Southwest's leadership has written off key commercial innovations and revenue opportunities across the airline industry for the last 15 years

Management Has Historically Ruled Out Industry-Standard Commercial Initiatives...				
	DELTA	UNITED	American Airlines	Southwest
Assigned Seating	✓	✓	✓	✗
Premium Products	✓	✓	✓	✗
Basic Economy	✓	✓	✓	✗
Checked Bag Fees	✓	✓	✓	✗

...Despite Skepticism From Investors and Industry Executives

Exiting of competitive hub airports drives questions of long-term competitiveness of Southwest's dated commercial strategy. [We] are concerned Southwest may need a strategic overhaul.

They put out an all-investor book about 'our passengers are our guests, and you wouldn't want to change your guests for their bags, but why do you change for the sake of it? That's the exact opposite of what we do here.

Management Opted for Small Changes...

To date, Southwest's approach has focused on incrementalism rather than an unbiased evaluation of all available opportunities

Initiatives Portrayed as Transformative Are Actually Incremental

"We have transformed before, adding things like WiFi, larger bins and in-seat power, and we will continue to adapt as needed."

CEO Bob Jordan, April 2024

Examples of Initiatives

- > Larger Overhead Bins
- > Upgraded Wi-Fi
- > In-Seat Power
- > Network Changes
- > Targeted Flight Adds
- > Growth in Core Cities
- > Mobility / Digital Tools
- > Flight Scheduling
- > Turn Execution
- > Training & Proficiency

These initiatives do not deliver the strategic evolution required to remedy Southwest's challenges. They are a normal part of running the business

Stronger Southwest

Board Changes

Southwest's Board needs new directors with the relevant experience to challenge the current strategy and the independence to hold management accountable

Upgraded Leadership

Southwest must bring in new leadership from outside of the Company to improve operational execution and lead the evolution of Southwest's strategy

Comprehensive Business Review

New management and Board-level committee will conduct a thorough review with the goal of modernizing Southwest's strategy and restoring best-in-class performance

SOUTHWEST AIRLINES: FINANCIAL DATA (\$bn)

FY (Jan-Dec)	2019	2020	2021	2022	2023	end March	2024
Revenues	22.48	9.05	15.79	23.81	26.09	Fleet and Other Equipment	19.56
Net result	2.30	(3.07)	0.98	0.54	0.46	Current Assets	2.78
Operating Cashflow	3.99	(1.13)	2.32	3.79	3.16	Cash and equivalents	10.52
Capex and Investments	(0.63)	(0.09)	(0.50)	(3.94)	(3.52)	Right of Use and Others	3.16
Free Cashflow	3.36	(1.22)	1.82	(0.15)	(0.36)	Total Assets	36.02
Financing *	(0.29)	10.37	(0.40)	(2.83)	0.59	Long term debt and leases	9.96
Dividends/share buy backs	(2.37)	(0.64)			(0.43)	Current liabilities	12.23
Total Change in Cash	0.70	8.51	1.42	(2.98)	(0.20)	Taxes etc	3.63
						Total Liabilities	25.82
						Shareholders' Equity	10.20

Notes: *Includes net proceeds from buying and selling short term financial instruments

share price, either through the success of changes it forces or through the defensive response of the incumbent management.

Southwest has an attractive balance sheet with a net asset value of \$10.2bn as at the end of Q1 2024, and, critically, it also has \$10.5bn in cash, which could be used for share buy-backs.

The Southwest Board, having failed at being nice to Elliott, have now decided on a “poison pill” defence: if Elliott’s stake exceeds 12.5%, the other shareholders will have the right to purchase new shares at a discounted price. The Board are in effect relying on the other institutional investors to support its strategy against Elliott’s proposition by putting more cash into the airline. There is no guarantee of success; the investors might decide not to protect an underperforming management team or they might anticipate that Elliott will respond by offering an increased price for Southwest shares.

Certainly, Elliott has picked up on disaffection among the equity analysts who follow Southwest. For instance, Jamie Baker of JP Morgan

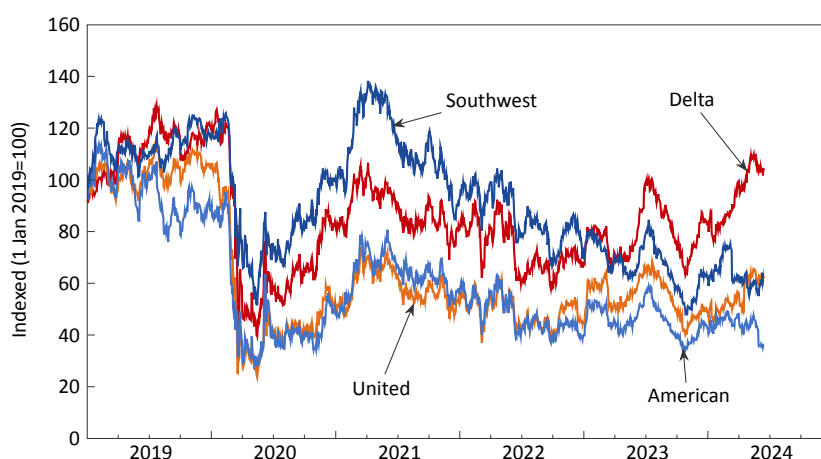
Chase characterised the management’s tone at the Q1 2024 results presentation as “grim”, a description refuted by Bob Jordan.

Elliott quotes Deutsche Bank’s comment that “investors are not convinced that the company can return to its former glory”. Specifically, Elliott refers to the decline in the airline’s Enterprise Value (stockmarket capitalisation plus net debt), which it calculates as being currently \$16bn (less that the market capitalisation, Southwest having

negative net debt) as against \$41bn in 2017. Elliott then compares this \$16bn figure to a theoretical value of the fleet of \$17bn (Cirium data) and reaches the questionable conclusion that the airline creates no net value from operating the largest domestic fleet in the US.

Elliott presents Southwest as markedly lagging its competition in terms of recent unit revenue and unit cost trends. But the comparisons it makes are with the Legacies — Delta, United and American — which have

SOUTHWEST SHARE PRICE PERFORMANCE v LEGACIES



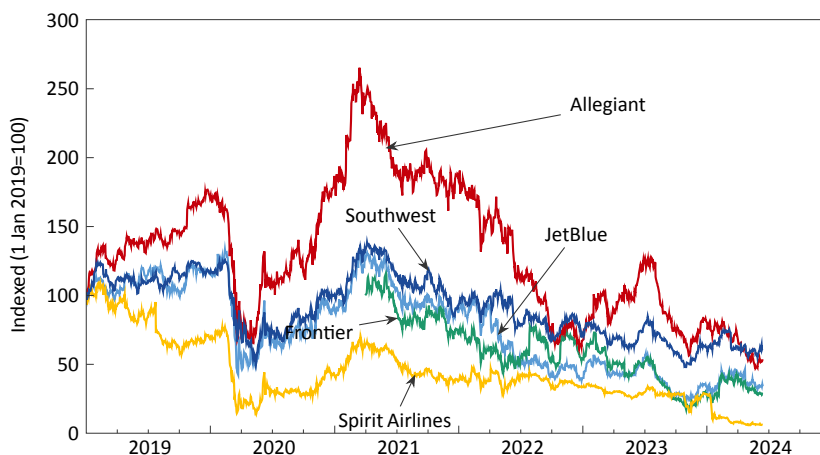
all benefited from the re-opening of the intercontinental markets post Covid as well as more benign competitive environment following the airline consolidation process. Elliott curiously ignores the competitive impact of the ULCCs on Southwest.

While Elliott focuses on the 20% decline in the share price over the past year, the two charts on pages 7–8 give a more nuanced picture of Southwest’s share price trends relative to pre-pandemic 2019. Compared to the Legacies, Southwest is somewhere in the middle, only clearly outperformed by Delta. Compared to the ULCCs — Frontier, Spirit and Allegiant — Southwest’s decline has been less severe. The other LCC, JetBlue, entangled itself in the failed attempt to take over Spirit, with the result that its share price has collapsed.

Long gone are the days when Southwest regularly produced industry-leading net margins of 20%-plus. In pre-pandemic 2019, despite the MAX problems, Southwest produced a net profit of \$2.30bn, which represented a margin on revenue of 10.2% (better than the three main Legacies). But post-pandemic 2023 was disappointing — a net profit of \$0.46bn, a 1.8% margin (worse than Delta and United, slightly better than American). With capex resuming, Southwest’s free cashflow was negative to the tune of \$(0.36bn) which meant that the restored dividend of \$0.43bn had in effect to be financed through borrowing.

The 2024 outlook is unpromising. Southwest has guided to a RASM annual decline of 4-4.5% for Q2, compared to 1.5-3.5% previously, while CASM could be up by about 7%, compared to zero change previously. Elliott jumped in with more criticism: “yet another example of the funda-

SOUTHWEST SHARE PRICE PERFORMANCE v LCCs



mental leadership change urgently needed at Southwest”.

The MAX situation

Nowhere in the presentation does Elliott examine the main external issue impacting Southwest since 2019 — the 737 MAX crisis.

A central tenet of Southwest’s operating model has been adherence since the beginning to a single aircraft type — the 737 — bringing economies in terms of crewing, training and maintenance, simplifying scheduling and route development decisions, and obtaining very

favourable pricing and conditions from the manufacturer in return for exclusivity. However, as former CEO, now Executive Chairman, Gary Kelly put it when the extent of the MAX problems started to emerge in 2019: “This ... illustrates the risk of having all your eggs in one basket”.

As of Q2 2024 Southwest had 495 MAXes on firm order, plus 199 options. At the beginning of this year, it had 85 deliveries scheduled 2024, but the current expectation is for just 46 units. The MAX 7, for which Southwest is the launch customer, will not be delivered until 2025/26. Conse-

SOUTHWEST’S MAX CONTRACT WITH BOEING
(As at end April 2024)

	MAX -7	MAX -8	Total	Options
2024	27	58	85	
2025	40	19	59	14
2026	59		59	27
2027	19	46	65	25
2028	15	50	65	25
2029	38	34	72	18
2030	45		45	45
2031	45		45	45
Total	288	207	495	199

quently, the carrier has been forced to reduce the number of 737NG retirements this year from a planned 49 to 25 units.

This impacts directly Southwest's ability to reduce its unit costs through increased fuel efficiency, lower maintenance charges and higher seat capacity. It has also damaged southwest's marketing, partly because of the travelling public's unease about this aircraft.

Culture: Luv lost?

Elliott are highly critical of Southwest's "outdated" strategy, lambasting the top management for having no experience outside Southwest while at the same claiming that they have damaged the brand.

Southwest's greatest asset has probably been its culture — efficient, friendly service at reasonable prices delivered by a dedicated, well-trained workforce — the LUV ethos that was established by the first two CEOs, Lamar Muse and Herb Kelleher. There is little doubt that that culture has become diluted since the 1970 and 80s perhaps because subsequent CEOs didn't have the same charisma, nor focus on the fundamentals, as the originals. The Elliott presentation quotes Michael O'Leary as saying that Southwest has lost its passion for low cost.

Yet it is difficult to see how the Southwest culture could be improved by this opportunistic attack. Elliott strongly recommends new top management, but from where? Their analysis suggests that executives from full-service carriers are needed (assuming that MOL isn't a candidate for CEO), but they are unlikely to have a deep understanding of the LCC model. Spreading content among workforces at target companies is not exactly an Elliott strength.

JD POWER: NORTH AMERICAN AIRLINE SATISFACTION SCORES 2024

Economy/Basic Economy	Score (Out of 1,000)
Southwest Airlines	685
Delta Air Lines	651
Allegiant Air	633
Alaska Airlines	630
JetBlue Airways	630
American Airlines	611
WestJet	591
United Airlines	585
Air Canada	542
Spirit Airlines	507
Frontier Airlines	472
Segment Average	613

And despite the criticism, Southwest, the largest domestic US airline by passengers carried (172m in 2023) still has many admirers. In the standard airline consumer survey carried out this year by JD Power Southwest was placed top in the Economy/Basic Economy category, clearly ahead of the Delta, the best of the Legacies.

Strategies and Tactics

Elliott presentation tails off when it comes to the solutions (the "pathway" and "case" parts of its methodology). There are multiple references to assigned seating, baggage fees, premium products, items normally associated with Legacy or Network carriers. But there is no vision for a radically changed "Stronger Southwest" (unless Elliott is hiding its masterplan). Engineering a merger with another LCC or ULCC to create a new force in the US market was a remote possibility, but such a development is now impossible following the JetBlue/Spirit anticompetitive ruling (*Aviation Strategy*, March/April 2024).

So Elliott seems to be suggesting

that Southwest should model itself on the three Legacies. But for Southwest to emulate these carriers, it would have to abandon its LCC operating model. Southwest has adhered to its point-to-point model throughout its evolution, characterised by using secondary airports wherever possible, rapid aircraft turns of 20 minutes or so, and intense rapid build-up of frequencies once it starts up a route.

The point-to-point model achieves economies through efficient rostering of flying and ground crew, and through superior aircraft utilisation — Southwest pre-pandemic generally achieved 1-2 hours more flying per aircraft per day out of its 737s over the narrowbody fleets of the Networks.

Yet a significant portion of its traffic, about 23%, is now connecting. This is particularly the case at its centrally located airports — notably Chicago Midway and Denver. Southwest manages to capture these traffic flows without compromising its operating model. Whereas Network carriers design waves of flights arriv-

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ing and departing within narrow time periods, with inactivity in between, Southwest schedules for maximum aircraft utilisation, with the passenger self-connecting.

Southwest has a limited international network focused on the Caribbean, accounting for less than 4% of its total capacity. It could not build global intercontinental hubs like the three Legacies.

Without a radical new strategy, Southwest management continue to

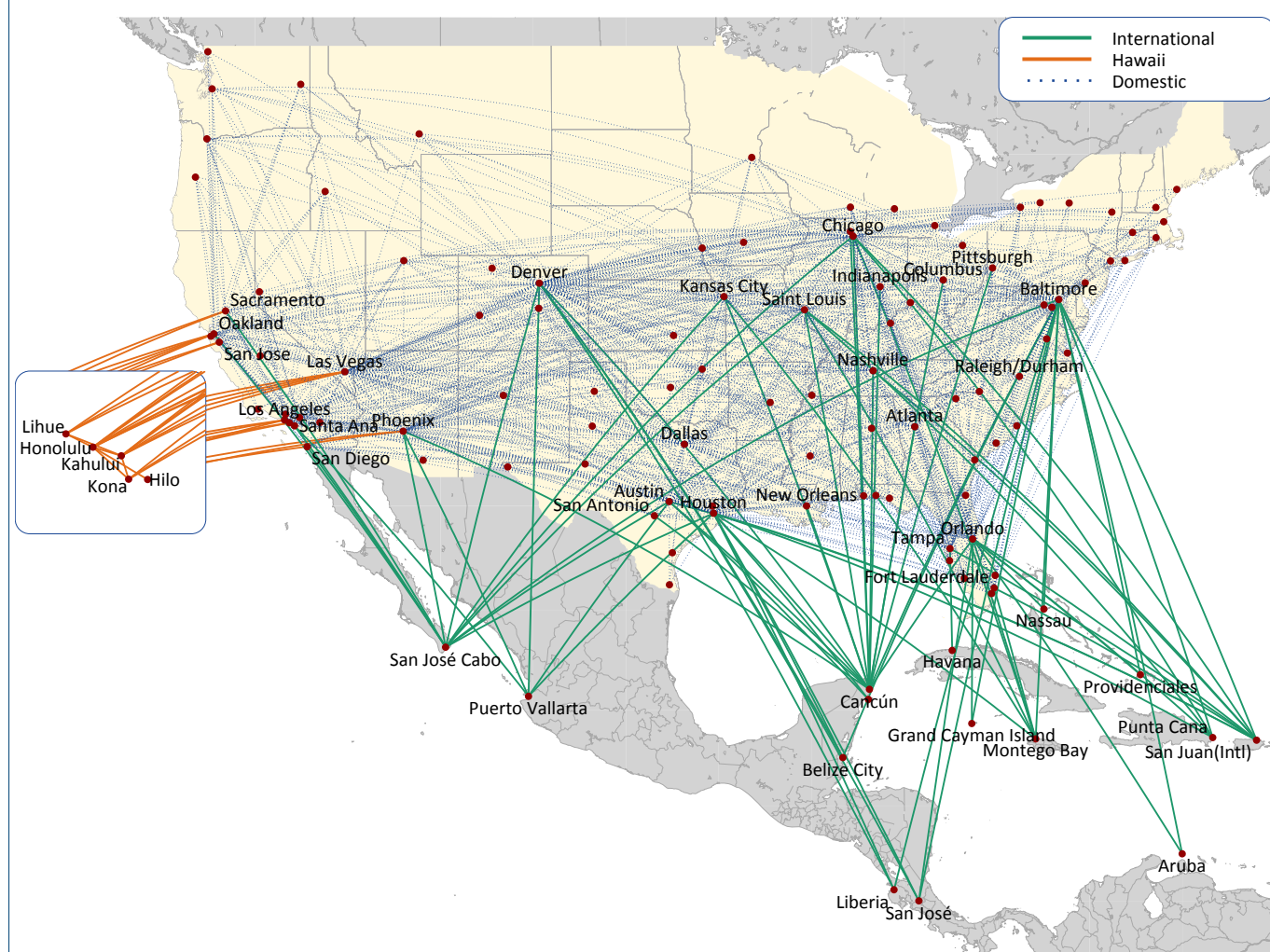
work on what are essential tactical questions — the culling of unprofitable routes (four cities have been closed this year and operations downsized at Atlanta and Chicago O'Hare); the possible introduction of some baggage fees; whether designating seating and marketing premium products is viable; how to reduce turnaround times by five minutes. This involves detailed operational analysis, quantifying the pro and cons, then careful implementa-

tion to improve profitability (maybe accepting that the historic margins are no longer achievable).

Elliott's intervention might help by shaking up complacent managers, but the activist investor's only real interest is in the share price.



SOUTHWEST ROUTE MAP



American: What happened to the Dream?

WHAT HAS gone wrong at American Airlines? It is the world's largest airline under various measures: the largest number of aircraft with a fleet of over 1,500 tin cans; it carried more than 210 million passengers in 2023. But it trails its major network competitors in the US (the world's next two largest airlines) in terms of revenues, margins, profits and balance sheet health.

A decade ago, American emerged from Chapter 11 bankruptcy protection and acquired US Airways to provide the last element in the consolidation of the US Legacies. That filing for Chapter 11 had been forced on it by the bankruptcies and restructuring (and subsequent consolidating mergers) of its two main rivals Delta/Northwest and United/Continental. But it emerged substantially larger and with a competitive cost base. Between 2014 and 2019 American reported a period of very strong earnings, with its operating profit margin peaking at 18% in 2015.

But in that period, they also used a large portion of cash flow to pay dividends and buy back shares to "reward investors". This left the group with a negative shareholders' equity of \$(118)m as they entered the existential crisis of the pandemic.

And since 2014 the group has been through a massive fleet renewal process. Between then and 2022 it took delivery of 630 new aircraft, retired 580 planes and, it claims, delivered the largest reconfiguration programme in aviation history.

It suffered badly (as any airline did) when Covid hit: in the two years of the depths of the pandemic it lost \$11.5bn at the operating level and \$10.8bn at the net — although this was only half the profits it had garnered in the previous five years. The group raised \$3.3bn in new equity but it also took on a lot of debt to cover these losses: total long term debt and lease liabilities peaked at \$48bn in June 2021 up from \$29bn at the end of 2019 (excluding pension liabilities of over \$6bn). Shareholders' equity at the end of June 2022 stood at a deficit of \$(7.7)bn.

The crisis gave it the opportunity to progress the fleet renewal. Since 2019 American has reduced the number of aircraft types in its mainline fleet from eight to four — disposing of A330s, 767s, 757s and E190s to concentrate on 777s, 787s, A320s and 737s — which has left it with a fleet age at the end of 2023 of 13 years.

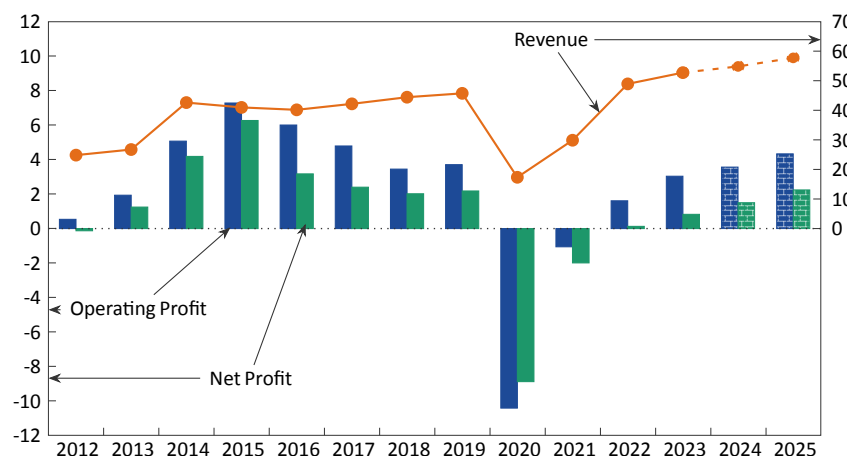
Investor Day optimism

At the beginning of March, the group held its first Investor Day in seven years. Led by CEO Robert Isom (who took over the position in 2022) the presentation described a return to strong profitability, targeting EBIT-DAR margins of 15-18%, annual free cash flow of over \$3bn by 2026, and debt (including pensions) back below \$35bn. Isom's story is that American has five main value-creating drivers:

➔ **Fleet:** The aircraft fleet is relatively young and has been simplified through the massive renewal programme since 2014. Capital expenditure is likely to be no more than \$2-3bn a year.

➔ **Operational excellence:** American claims a strong reliable operation, boasting a 98.9% completion rate in 2023. It even managed on time performance of 79%, slightly behind Delta and Alaskan.

AMERICAN AIRLINES GROUP: FINANCIAL DATA (\$bn)



Source: Company Reports. Forecasts Bernstein.

AMERICAN AIRLINES GROUP: FINANCIAL DATA (\$m)

	2019	2020	2021	2022	2023	@ 31 Mar	2024
Turnover	45,768	17,337	29,882	48,971	52,788	Operating property*	39,056
Net profits	1,686	(8,885)	(1,993)	127	822	Intangibles and other	10,786
Operating cash flow	3,815	(6,543)	704	2,173	3,803	Cash†	9,195
Net capex	(3,203)	(964)	(51)	(3,080)	(2,091)	Current assets	5,347
Free cash flow	612	(7,507)	653	(907)	1,712	Total Assets	64,384
Increase in debt	(293)	8,024	4,828	2,631	(3,206)	Current liabilities	(24,993)
Equity	(1,275)‡	2,970	460			Debt§	(34,685)
Total cash flow	(956)	3,487	5,941	1,724	(1,494)	Other liabilities	(10,206)
						Total Liabilities	(69,884)
						Shareholders' Equity	(5,500)

Notes: * inc right of use assets; † inc short term investments; § inc leases; ‡ Dividends and treasury shares

✈ **Network:** it claims to have the strongest domestic and short-haul international route network.

✈ **Rewards:** its AAdvantage FFP is a leading travel rewards programme. But its co-branded cards agreements were last established ten years ago. It is looking to renegotiate agreements (with Citi and Barclays?) seeking a bank to create “the largest branded credit card”.

✈ **Re-engineering the business:** The simplified fleet is seen as providing a route to better asset utilisation; and the group is taking a deep dive into its procurement processes.

On the same day the group announced that it had placed an order for 85 A321neos, 85 737-MAX 10, and 90 Embraer 175, complementing its existing orders for 787s and A321XLRs (see table on the facing page).

Building the best network

CCO Vasu Raja tried to explain the commercial game-plan, stating: “Our short haul network is the foundation of value for customers and investors. AAdvantage is our source of value growth for customers and investors”.

From his point of view, Ameri-

can is a uniquely positioned global hub-and-spoke network carrier with a strong benefit from its sun-belt focus. Five of its largest hubs — Dallas, Phoenix, Los Angeles, Charlotte and Miami (see map on page 14) — are in this region of the southernmost 18 states of the Union.

He proposes that the customer landscape is changing to American’s advantage. The population in the sun-belt states is growing: 7.6% up (12m people) in the past decade compared with 2% for the rest of the country, and forecast to increase by a further 7% in the next ten years (against 0.3% for all other states). Economic growth is trending similarly, with the sun belt economic performance between 2019 and 2022 some 124% of the national average.

Raja also suggests the competitive landscape is changing — again to American’s advantage. In 2023, the country’s 25 largest air markets had 2% more seats on offer than flown in 2019. But the 200 smallest markets had 11% fewer seats. Moreover, the 200 smallest markets in its network generated yields 63% above its average (and the largest markets 2% be-

low average). He also states that 60% of the country’s airports have fewer than 500 passengers a day. Regional connectivity may have fallen as the majors concentrated on up-gauging — but American retains its huge fleet of regional jets with their lower trip cost advantage.

He exemplified the “unique network advantage” by using El Paso, Texas (a city of 0.6m population). American provides 14 peak-day departures with non-stop flights to four hubs (Los Angeles, Dallas, Phoenix and Chicago) delivering “global connectivity to more than 175 cities”.

He went on to argue that the American network creates the most value for customers: American, he averred, offered 30% more O&D markets than other carriers; 40% of O&D markets are unique to American; and, more than 45% of domestic traffic originates outside domestic markets. He also claimed that American offers “a superior network” (whatever that really means) in 68% of markets (up from 59% in 2019 and 51% in 2014).

✈ International network

Raja commented that American’s operational focus is predominantly

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AMERICAN AIRLINES FLEET

		Avg seats	Avg Age	Dec 2023	△ v2019	Planned deliveries						Total	
						2024	2025	2026	2027	2028	2029+		
Widebodies	A330-200	247			↓15								
	A330-300	291			↓9								
	767-300ER	209			↓17								
	777-200ER	273	23.0	47									
	777-300ER	304	9.8	20									
	787-8	234	5.1	37	↑17	}	6	5	4	5	5	5	30
	787-9	285	6.2	22									
Total			12.7	126	↓24	6	5	4	5	5	5	30	
Narrowbodies	A319	128	19.7	133	↑1								
	A320	150	22.7	48									
	A321	178	11.4	218									
	A321neo	195	2.9	78	↑66	3	16	21	31	14	64	149	
	737-800	172	14.1	303	↓1								
	737-8 MAX	172	3.2	59	↑35	20	14	10		20	95	159	
	757-200	180			↓34								
	E190	99			↓20								
Total			13.0	839	↑47	23	30	31	31	34	159	308	
Mainline			12.9	965	↑23	29	35	35	36	39	164	338	
	CRJ	66		254	↑7								
	ERJ	70		302	↑9	12	12	18	15	15	30	102	
Regional				556	↑16	12	12	18	15	15	30	102	
Group Total				1,521	↑39	41	47	53	51	54	194	440	

domestic — which accounts for over 70% of the Group's passenger revenues. But, as a member of the oneworld alliance, it has links and partnerships “with other high-quality carriers” round the world.

Somewhat strangely, Raja claims that American's network along with its partners “serve c90% of US long haul demand”.

On its international network (see map on the following page) it has a strong historic position in Latin America — heavily concentrating on short-haul services into the Caribbean and destinations in Central America — where its sun belt hubs provide an advantage. In 2022 American tied an agreement with Brazilian carrier GOL with a \$200m investment (snatching the

airline back from Delta's clutches) to reinforce codeshare partner benefits in Southern America. The LatAm operations generated 14% of the group's 2023 passenger revenues.

On the Atlantic (which accounts for a further 13% of revenues) it has a joint venture with IAG — the most valuable part being the link between the North East coast of the US and London (New York and London representing the two largest gateways on the North Atlantic). On routes to London, Raja pointed out that American achieves yields that are 24% higher than the average for the rest of Europe.

But with limited feed into New York and Boston, and the demise of the JetBlue Northeast alliance, it is at a slight disadvantage against its ma-

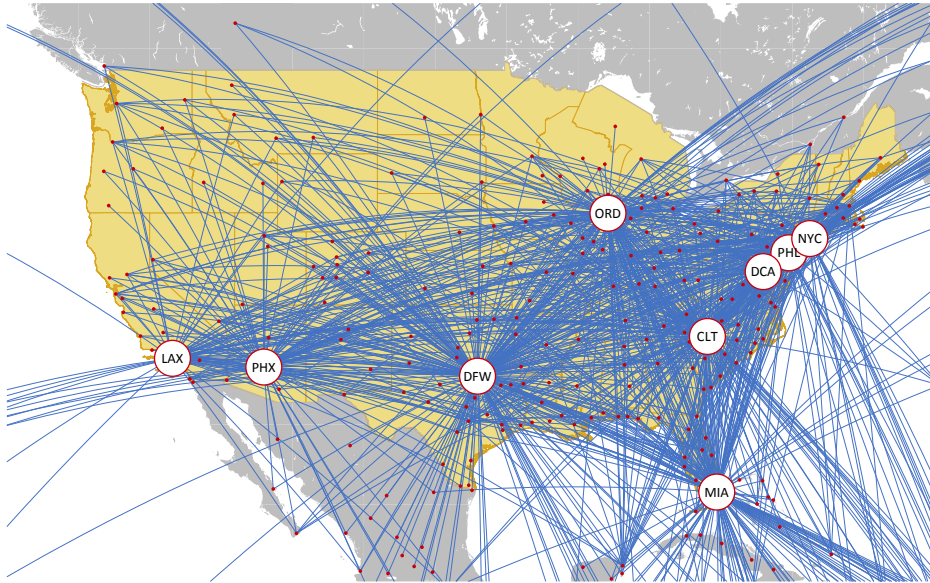
jor competitors. American's strategic alliance with Alaska Airlines covering its lack of presence on the West Coast has managed to avoid regulatory opprobrium. American also has a strategic alliance with Qatar Airways for flights from select eastern seaboard flights into the Middle East and beyond.

American is relatively weak on the Pacific, but has a joint venture with fellow oneworld member JAL (and on flights to Tokyo, Raja states that that it achieves a 13% yield premium compared with its other Asian routes) and with Qantas on routes to Australia. It also has similar relationship, and a 1% equity stake, in China Southern for routes into the PRC.

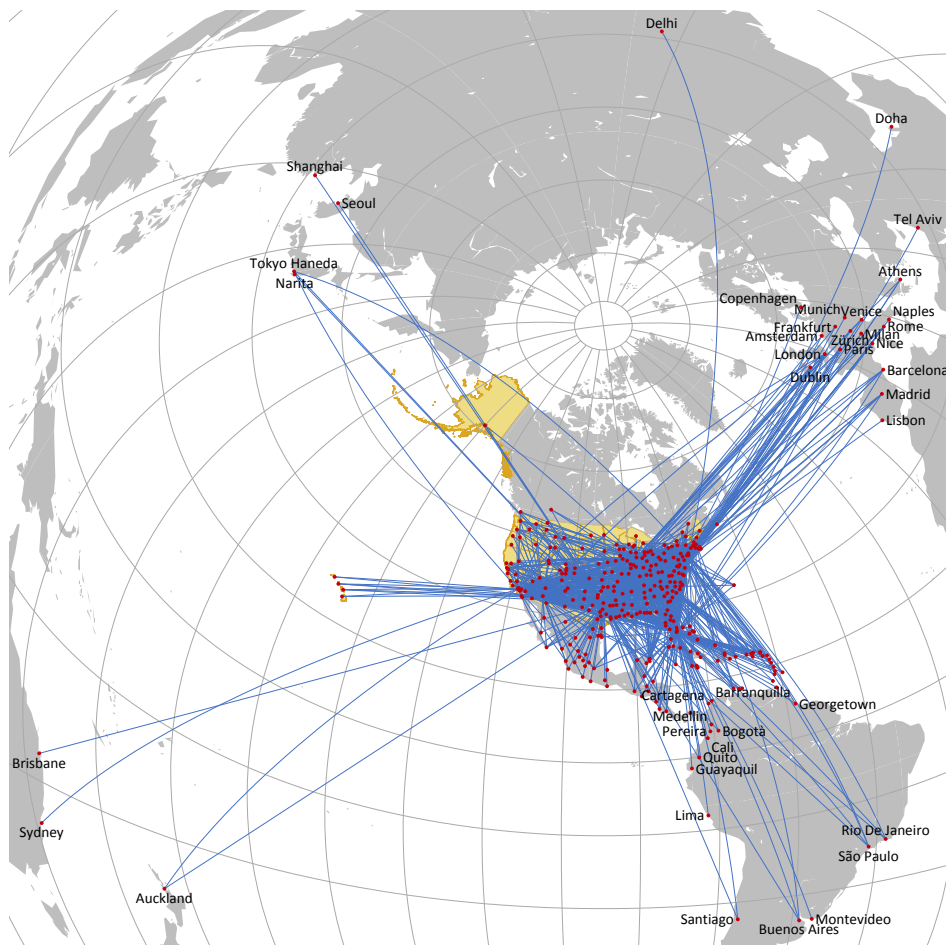
The major airlines publish figures splitting out passenger revenues by

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AMERICAN: DOMESTIC HUB NETWORK



AMERICAN: INTERCONTINENTAL ROUTE NETWORK



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geographic regions, but none provide a similar breakdown of profitability. In the graphs below we show figures for the regional performance taken from the DoT's Form 41 filings.

These seem to show that the three main carriers are much on a par in the Domestic market (with Delta consistently ahead of the pack), but that American is at a structural disadvantage to its two main rivals on the Atlantic and Pacific.

However, the numbers for Amer-

ican on the Atlantic are somewhat unbelievable — given the comments from British Airways (and Iberia and Aer Lingus) on the power of profitability on the route that is operated as a metal neutral joint venture, it seems unlikely that American is actually losing money in such a consolidated, business-orientated market..

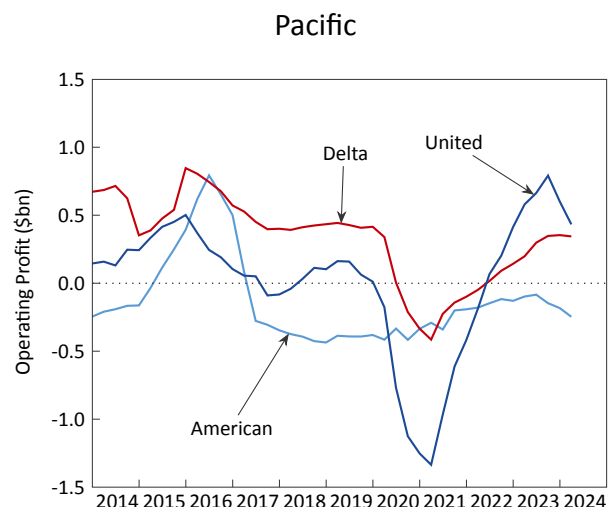
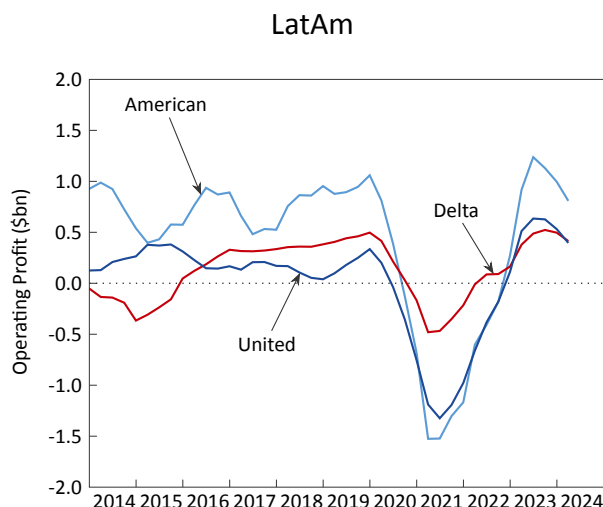
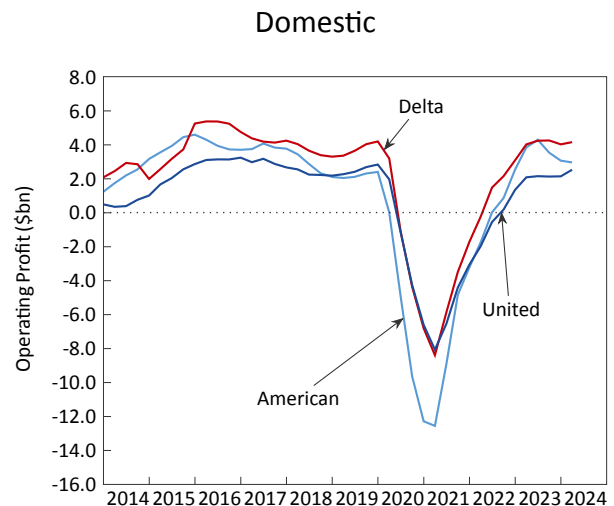
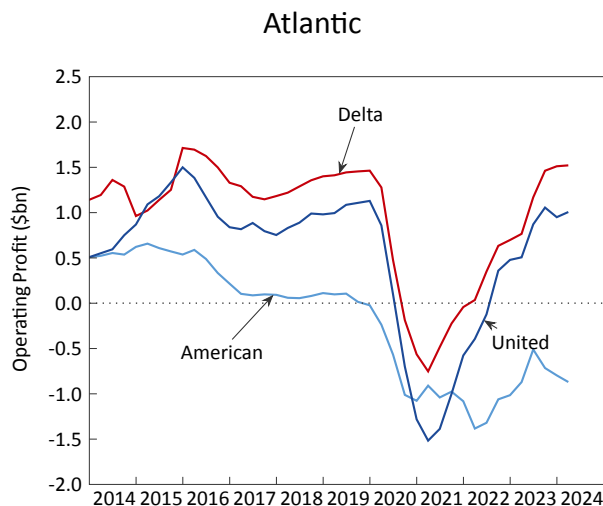
It could be that the Form 41 filings, developed in the heavily regulated era, are just not suited to dealing with the wonders of hub-and-

spoke networks and the secrecy of joint ventures. It could be that American fudges the figures it files.

Building the best travel rewards

AAdvantage was one of the first FFPs to be established (in 1981). It is one of the largest programmes in the world, boasting over 115m members. Vasu Raja said that in 2023, 65% of American's revenue came from passengers who were members of the programme (up from 55% in 2017) —

REGIONAL PROFITABILITY (LTM)



Source: DoT Form 41

Note: LTM=latest twelve month

40% travelling in premium products, 25% in the back of the bus. A further 15% of revenues came from passengers travelling in premium seats who were not (yet) members of AAdvantage. (They still need the other 20% of revenue, but cannot say it's a priority). He added that American "offer more premium seats than any other airline". Apart from the handful of new aircraft due in the next few years, American will be retrofitting old A319s and A320s with more first class seats, and expects that this inventory should grow by 20% over the next two years.

But he also suggested that AAdvantage is "underpenetrated in the travel landscape" — active members accounting for 23% of US air passengers, but the co-branded credit cards only 6% of air travellers.

So the programme has been re-engineered: to make it "easier" for customers to earn miles; "easier and cheaper" for companies to manage bookings; and more efficient for American.

For customers to earn miles they have to use direct channels or "modern retailers" — ie those with New Distribution Capabilities (NDC). Miles are issued on a sliding scale depending on total dollar spend, status, and method of payment. No miles are issued if a member books through a "non-preferred" agency. A fare in basic economy bought through "direct channels" gets the punter 2 miles per dollar spent. A "main fare" bought through modern retailers gets her five miles per dollar. If she has "status" this goes up to 7-11 miles/\$, and using the co-branded credit card, having "status", generates up to 16 miles/\$. (When the changes were rolled out in February, it appears that American failed to announce which travel agencies it considered "preferred agencies".)

Raja also boasts that AAdvantage offers the "most redemption value" of any reward points with a third party valuation of 1.7¢/mile, and provides "unique and unmatched benefits across the travel journey, un-

locked with status".

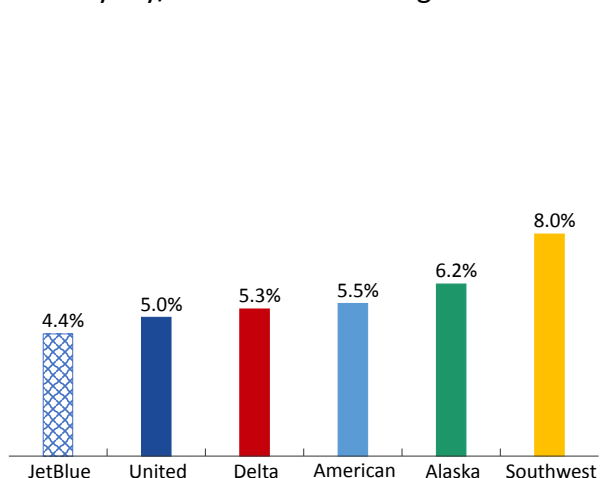
For corporate bookings Vasu Raja said they had eschewed the traditional model whereby customer bookings were routed through intermediaries. The business would pay agency fees to a travel management company, who would also get fees and commissions from the airline. The passenger would be credited with the base miles and loyalty points. The main point seems to be that this process used outdated technology and provided an unwanted layer of complexity.

The new programme, dubbed AAdvantage Business, was designed to cut out the middleman, and get the business to book directly (rewarding both the business and the traveller with miles and elevated loyalty points). Raja suggested that it would make it "80% less expensive for customers and 65% less expensive for American".

Loyalty programme revenues, from marketing (co-branded cards) and from redemption, are a vital

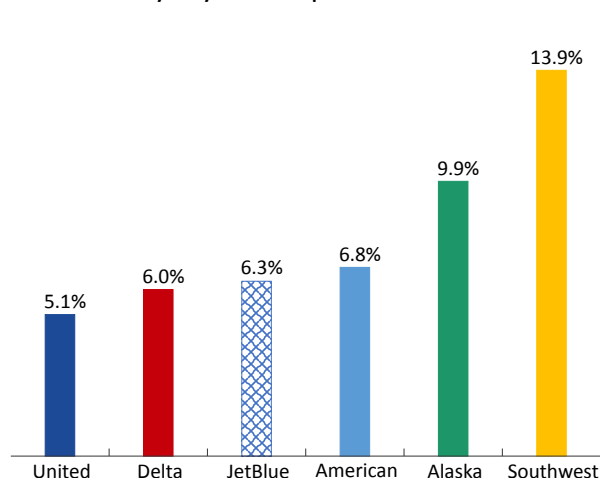
US CARRIERS LOYALTY REVENUES (% Total Revenues 2023)

Loyalty/Co-brand marketing revenue



Source: Company reports, Barclays Research

Loyalty redemption revenue



Labor Tensions

Cockpit

In 2023 all the major US carriers negotiated new pay contracts with their respective pilots' unions.

The pay awards seem staggeringly good (for the pilots), with backdated increases of over 20% and guaranteed uplift in rates over the remainder of the contract to raise wages by 45-50%. Each of the deals at American, Delta and United had side deals to make sure that if one of the competitors offered better pay, rates would snap up to match.

But then the pilots are in a strong bargaining position: there is a general shortage of trained commercial pilots. It seems that many took the opportunity of early retirement during the pandemic—but the average age is still in the mid-40s and some estimates suggest that 50% of the corpus will reach mandatory retirement age of 65 (raised from 60 in 2009 to address the then pilot shortage) in the next 20 years.

And there is a structural regulatory constraint in that trainees have to amass 1,500 flight hours (and a four-year university degree) before they can be considered for employment in commercial aviation.

Cabin

This is the year for the Flight Attendants (who don't have the carriers over a barrel in quite the same way).

Southwest concluded an agreement in May giving its cabin crew a 22% increase in wages along with \$364m retroactive earnings and promises of 3% increase in each of

the next three years.

The agreement, it is said, will make them some of the highest paid flight attendants in the industry. They also will get maternity/paternity leave (which their union describes as an industry first), holiday pay and additional compensation for time spent on the ground (they are typically only remunerated for time worked inside the aircraft).

In June, Alaska signed a new contract with their crew (no details public as yet).

United and American are also bogged down in negotiations.

The American contract became renegotiable in 2019. At the first quarter results call, CEO Robert Isom expressed optimism that a deal would be struck. And then in June, negotiations broke down again and the union is pressing for strike action.

Strikes

But airline employees in the US are not really allowed to strike.

This is all because of the 1926 Railway Labor Act (which was extended to cover aviation in 1936). Irreconcilable differences have to be negotiated under auspices of the National Mediation Board (NMB). Unless, that is, the NMB gives the union leave to take industrial action (after a 30 day cooling off period).

The last pilot strike was in 2010 (at Spirit); and the Mechanics walked out at Northwest in 2005.

Pilots at American Airlines started strike action in 1995. It lasted all of 24 minutes: the then President Clinton invoked pow-

ers under the Railway Labor Act to force an emergency suspension and require mediation through a Presidential Emergency Board.

Flight Attendants at American last walked out in 1993, just before the Thanksgiving peak travel period. American continued flying operations, carrying parcels in place of passengers. That time Clinton "brokered a settlement". The strike lasted five days.

This year, some political sensitivities come into play. The NMB would not want President Biden, who some have called "the most pro-union ... pro-worker president that this country has ever seen" to be forced into siding one way or the other. In an unusual move, American and the cabin crew representatives were summoned to a Saturday meeting of the NMB in Washington (it does not work on Saturdays), and told to negotiate.

One can have some sympathy for the Flight Attendants. They have not had a pay rise for five years – and this during a period of high inflation. Some are paid so little that they have become eligible for "food stamps" – as the federal Supplemental Nutrition Assistance Program (SNAP for short) is known.

A series of picket lines were established at some 30 airports in the US on the Worldwide Flight Attendant Day of Action in June (which followed shortly after International Flight Attendant Day on May 31).

Engineers

In 2025 American's contract with its Machinists come up for negotiation. That might also be interesting.

part of the US industry profitability and liquidity. In 2023 American received cash payments of \$5.2bn from co-branded cards and other partners.

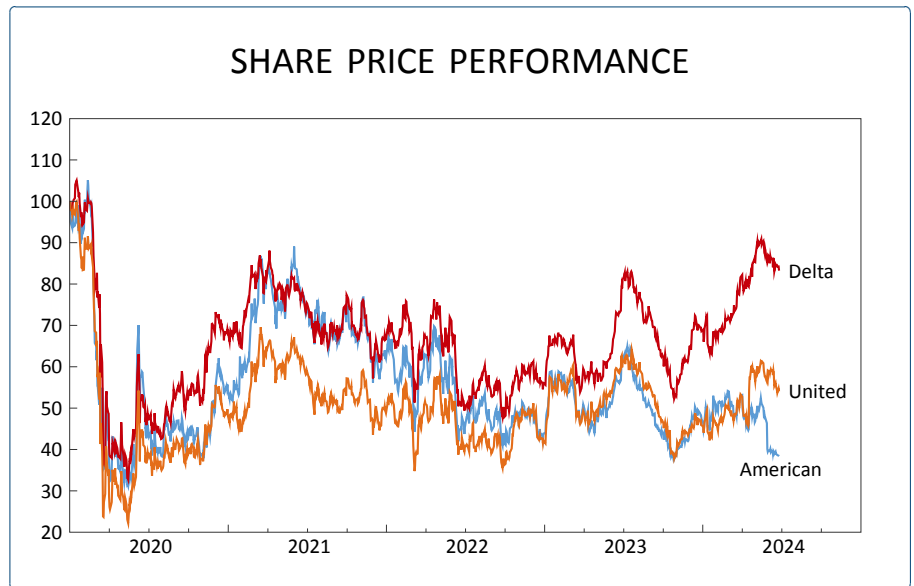
Volte Face

What CCO Visu Raja and CEO Robert Isom may have failed to recognise is that airline customers have a choice; or indeed identified who the customer is. As one disgruntled travel manager at Lockheed Martin, quoted in *Travel Weekly*, pointed out “Managed corporate travel programs manage their respective traveler groups, not the airlines. AA needs to realize that the corporate travel programs are their customers, not our travelers. Cater to the managed travel program’s needs, don’t try and fracture our programs by trying to push travelers into booking direct.”

Two months after the Investor Day presentations, at the end of May American was forced to issue what amounted to a profit warning, on the eve of a presentation at Bernstein’s annual Strategic Decisions Conference.

Total unit revenues in the quarter ending June were now expected to be 5-6% down from prior year levels, compared with earlier guidance suggesting declines of 1-3%; it had failed to implement capacity growth with ASMs expected to be flat year on year, down from c8% growth; its estimate of operating margins in the quarter was reduced by 1 percentage point to a range of 8.5%-10.5%; it now expected Q2 earnings per share of \$1.00-\$1.15 compared with guidance of \$1.15-\$1.45 made a month before. On the announcement, the shares fell by 14% in a day — the largest single-day drop since early 2020 in the depths of the pandemic.

Robert Isom admitted that the implementation of the distribution



plan had been botched and had backfired, saying “We’re seeing softness in customer bookings relative to our expectations that we believe is in part due to the changes that we have made to our sales and distribution strategy.”

Speaking at that same Bernstein conference, United’s CEO, Scott Kirby, courteously suggested that the profit warning had more to do with American’s ability to forecast rather than distribution changes — United had been forced to put out a press release confirming their second quarter guidance.

The architect of that strategy, Visu Raja, was fired (after 20 years service with American Airlines), leaving the company from the beginning of June.

Isom said: “We can never be difficult to do business with... Others are benefiting from what we’ve done over the last six months or so. We’ll get that back.”; and “Raja has been an innovator... but sometimes we need a reset.”



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