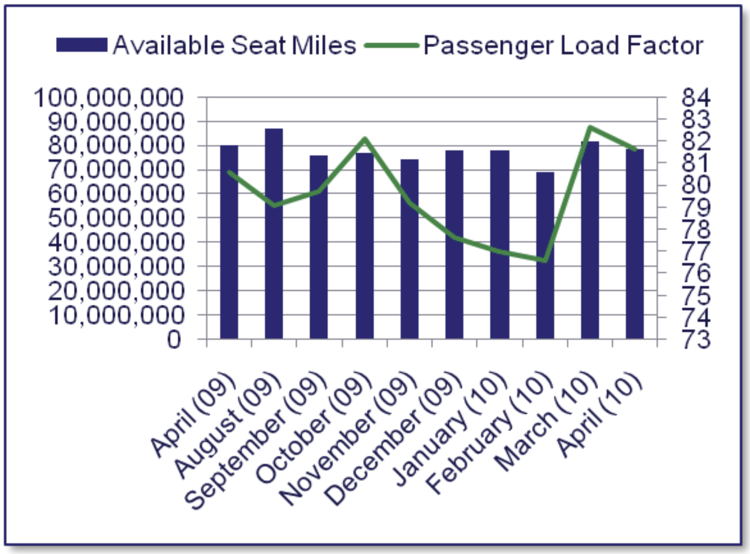
Long Term Questions in the U.S. Airline Industry

The most recent quarter has been kind to the U.S. airline industry with all major U.S. carriers posting the best profits in several years, with the exception of American Airlines.[1] Much of the recent success has been attributed to a rebound in the economy forcing demand upward, especially with business travelers who typically pay a premium. Despite this uptick, the major U.S. carriers are facing challenging strategic questions regarding capacity, labor relations, and forecasting. Although there is considerable optimism in the industry from the last quarterly reports, the long term issues persist and maintaining profitability will be a challenging task amidst uncertain fuel costs, global competition, and a wary consumer.

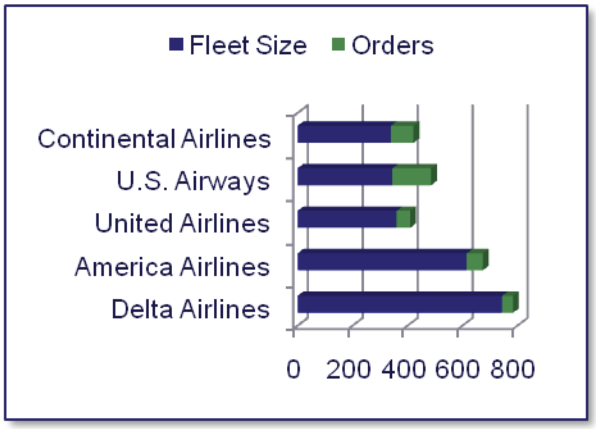
Capacity is Key Concern at Airlines



Capacity is likely to remain consistent at many of the major airlines, pushing prices and utilization of aircraft higher at each. The market has shown its distaste for an airline suggesting a planned increase to seats flown, with Delta being the prime example. They saw their stock price decline because they announced a plan to increase overall capacity by 3% in 2011 even though they reported profits of $467 million the same day, the best quarter for Delta in over a decade.[2] Although capacity may be increasing at Delta, overall capacity in the industry is likely to decrease with the merger of United and Continental. Assuming the merger receives regulatory and union approval, the volume of seats flown will likely decrease, pushing the prices higher and decreasing choice for consumers. We have already seen how limiting capacity has helped airlines become profitable in the 2nd quarter as overall utilization has increased by 2% in the month June 2010.[3]

Operating Costs Plague Legacy Carrier

Despite recent industry optimism, American Airlines labor relations continue to cause harm to their bottom line. At American Airlines, 30% of revenue is spent on labor related costs, which is 10% higher than the average of 20% at other major U.S. carriers.[4] The difference in labor costs is directly attributed to American Airlines' choice to not reduce wages while in the bankruptcy process. Although American Airlines chose not to use this as a central reason for the 2nd quarter loss, they did report a $10.7 million loss despite a 14% increase in fare price on average from one year earlier.[4] While the future of American Airlines is unclear, we do know that limiting an increase in capacity, despite an uptick in demand, will be critical for a third quarter profit.



Capital and Credit

In this highly competitive landscape, the U.S. airline industry as a whole is resting its fate on a new generation of fuel efficient planes and limiting capacity to ensure adequate revenue per available seat mile. The demand for fuel efficiency is a simple solution in theory, but efficiency targets remain elusive. Moreover, it is clear that airlines themselves do not have the capital to invest in these new models and reliance upon older, less fuel efficient planes remain the standard. At the Farnborough air show in 2010, $29 billion in plane orders were made, with $16.6 billion coming from recently created, plane leasing companies.[5] The volume of purchases by plane leasing companies suggests a long term concern for airlines, as credit and capital remain difficult for them to find. This may ultimately mean a shift in how airlines are forced to manage their fleet and revenues.

Long Term Profitability

Regardless of short term profits, the long term is speckled with questions, especially as airlines are already seeing hints of declining demand, as leisure and business travelers question the health of the economy.[3] If demand ultimately decreases with an ailing economy, it will lead to airlines looking for new sources of revenue, likely through new fees, while simultaneously reducing costs through decreasing capacity and jobs. If this happens, it may benefit the consumer, who will likely see better ticket prices, but will likely hurt the U.S. airline industry as the revenue per seat mile ratio moves negatively relative to the average cost per seat mile. No matter what happens in the broader economy, airlines must soon make decisions regarding fleet and route planning which will impact the long term profitability of the entire industry. Depending upon the decisions made, we will see if U.S. airlines can gain a competitive advantage, and remain nimble and profitable, while competing against much more profitable foreign carriers.

FCSI Insights

The competition in the U.S. airline industry is heated. With the growing pressure to reduce fares and fees and the ever increasing costs of fuel and labor, the ability to maintain long term profitability remains questionable. Knowing and understanding the direction of competitor action regarding fleet and route planning, capacity, hub utilization, and future macro-economic trends will drive future profitability. Demand for air travel appears to be waning and, heading into the 4th quarter, sustaining competitive advantage will become a challenge as airlines lower fares and offer additional perks to attract customers. Obtaining insights and information about one's competitive set can help drive a strategy that can produce effective practices and ultimately create a sustainable competitive advantage. Fletcher/CSI's General Practice Group conducts large scale review and analysis of major players in the transportation industry and drives actionable, executable, and measureable insights for clients.

[1] Marc Friedman, "United, US Airways, JetBlue report strong 2Q; American still in the red," Boston Examiner, 27 July 2010
[2] Ben Mutzabaugh, "Delta reports best result in a decade," USA Today, 19 July 2010
[3] David Koenig and Joshua Freed, "Airline profits may mean fare sales will wane," Associated Press, 27 July 2010
[4] Ben Mutzabaugh, "American looses money as some fear airline is slipping," USA Today, 21 July 2010
[5] Jane Wardell and Andrew Khouri, "Aviation industry upbeat as Farnborough nets $29 billion in deals," Associated Press, 24, July 2010