SOUTHWEST AIRLINES CO.

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EXECUTIVE SUMMARY

Southwest Airlines (NYSE: LUV), established in 1967, is a low-cost airlines carrier operating in the United States. They are the largest domestic carrier by volume, transporting 106 million passengers last year. Southwest also operates a small freight division. In May of 2011, Southwest acquired AirTran airlines, and is in the process of integrating their operations.

2011 was Southwest's their 39th consecutive profitable year. Using a model of selecting the most profitable point-to-point routes and operating them efficiently and with good customer service, Southwest has been able to sustain solid growth year after year. By the start of 2012, they were serving 479 city pairs and producing annual revenues of over $15 billion dollars.

As Southwest continues expanding, including the ongoing integration of AirTran's operations, it is important that they maintain the low cost structure that has made them so successful historically. As larger and more congested destinations are added to Southwest's routes, they must focus on customer service as the on-time arrivals and other metrics are certain to deteriorate, and they cannot afford to lose market share. Futhermore, if Southwest is to maintain their perennial profitability, they must convert AirTran to the point-to-point strategy and phase out their 717-200 aircrafts from service, since these add unnecessary complexity to the maintenance operations and other logistics. Additionally, in order to protect from volatile fuel prices, it would be prudent to expand the fuel-efficiency of the fleet by capitalizing on Boeing's most recent advances. Southwest must also maintain its position as the "hassle-free" low-cost carrier, with more subtle methods of collecting additional fees than checked baggage and reservation changes.

These strategies, combined with a continued dedication to customer service, will allow Southwest to maintain, and even expand, its market position in the coming years as air travel continues to grow in the United States.

HISTORY

On March 15, 1967, Air Southwest Co. was incorporated in Texas by Rollin King and Herb Kelleher to provide service within the state of Texas. Later that year, Kelleher filed the application with the Texas aeronautics Commission (TAC) to serve Dallas (DAL), Houston (IAH), and San Antonio (SAT) airports. While TAC voted unanimously to grant Air Southwest a certificate of public convenience on February 20, 1968, three incumbent airlines, Braniff, Trans Texas (later Texas International), and Continental Airlines obtained a temporary restraining order from Travis County District Court prohibiting TAC from delivering Air Southwest's Certificate. Although the lower courts ruled against Air Southwest, the Texas Supreme Court unanimously voted to overturn the lower courts' findings and ruled in favor of Air Southwest. The case was resolved on December 7, 1970, when the United States Supreme Court denied appeal by Braniff and Texas International (TI), and Air Southwest was finally ready to commence its service[1].

Air Southwest underwent series of changes after the regulatory struggles. On March 29, 1971, Air Southwest Co. changed its name to Southwest Airlines Co. On June 8, 1971, the company completed an Initial Public Offering of 650,000 shares of stock at $11 per share ($6.5 million). Operating from its Dallas, Texas Love Field headquarters, Southwest Airlines began customer service on June 18, 1971, offering service to the Texas cities of Houston, Dallas and San Antonio using three Boeing 737 aircraft.

The early years of Southwest Airlines saw operating losses. On May 13, 1972, Southwest sold its fourth aircraft to Frontier Airlines in order to cover payroll and other expenses.[2] Southwest continued to operate a schedule predicated on four aircraft but using only three. In this way, the "ten minute turn" was born and became the standard ground time for many years.[3] In 1973, Southwest announced its first profitable year and continued in the same fashion to this date.

Southwest Airlines quickly expanded its service in the late 1970s. It placed a sixteenth Boeing 737 aircraft into service in 1979, and had been granted right to serve from airports outside Texas such as OKC, TUL, and ABQ by 1980. On June 27, 1977, Southwest common stock was listed for trading on the New York Stock exchange under the ticker symbol "LUV.[4]" Southwest achieved record breaking traffic statistics for 1980 reflecting a 28% increase in revenue passenger miles and a 20% increase in passenger boarding to 5,976,621 compared to 1979 results.

In the 1980s, Southwest continued to expand its service and financed the expansion through issuance of corporate debentures. During this period, Southwest inaugurated new service from about ten airports including LAS, SFO, and PHX. It also acquired several Boeing 727-200 and 737-300 aircrafts to keep up the pace of its growing business. In 1985, Southwest payed about $40 million in cash and $20 million in stock for one of its competitors, MuseAir.

As Southwest grew steadily in the 1990s, it started to focus on establishing its corporate culture and public image. In 1998, Southwest launched the "Kids Fly Free" vacation program with Disneyland. The "Give Your Heart Wings" program of 1999 encouraged Southwest Airlines' Rapid Rewards members to donate valid unused award tickets to Southwest Airlines for distribution to nonprofit organizations in their communities. On December 20, 1997, Southwest Airlines ranked first on Fortune magazine's "100 Best Companies to Work for in America" list. During this period, Southwest further expanded its service to the south and northeast part of America.

In the early 2000s, while the airline industry as a whole was severely impacted by the 9/11 terrorist attacks, Southwest Airlines was able to recover quickly. Three days after the attacks, Southwest resumed service. Over the following days, weeks, and months, other airlines laid off thousands of employees and reduced flight schedules, but Southwest maintained both employment and its schedule.

One of the most significant successes of Southwest Airlines in the 2000s was the repeal of the Wright Amendment. The Wright Amendment of 1979 was a federal law governing traffic at Dallas Love Field (Southwest's headquarters), limiting most nonstop flights to destinations within Texas and neighboring states. In late 2004, Southwest began actively seeking the full repeal of the Wright Amendment restrictions. On September 29, 2006, U.S. Congress approved legislation to repeal the Wright Amendment, and it was signed into law by President George W. Bush on October 13, 2006.[5]

Moving forward, Southwest Airlines continued to launch new nonstop routes and inaugurate service from new airports in the late 2000s. In 2005, it agreed to a codesharing agreement with ATA Airlines, becoming more intimately connected until 2008 when ATA filed for bankruptcy. Southwest purchased their assets and operating certificate at this point, and ATA ceased operations[6]. In 2010, Southwest announced it had entered a definite agreement to acquire AirTran Holdings, Inc., the parent company of AirTran Airways (AirTran). In February, 2011, the Federal Aviation Administration approved Southwest's plan to combine its operations with AirTran, and the integration has been smooth thus far, with most executive positions and union seniority settled. Southwest now looks forward to expanding into AirTran's markets, and continuing to grow overseas as well.

FINANCIAL ANALYSIS

For the 39th consecutive year, Southwest Airlines was profitable, earning $178 million in 2011, though down from a net income of $459 million in 2010**.** The operating income for 2011 was $693 million, which was a 29.9 percent decrease versus 2010 (see Appendix for complete income statement). The primary driver for these downward trends was higher fuel costs. A 33.5 percent increase in the Company's economic jet fuel cost per gallon compared to 2010 was the primary reason for a $2 billion year-over-year increase in fuel and oil expenses. But, by generating a 29.4 percent increase in operating revenues, Southwest was able to remain profitable.[7] The table below shows Southwest's estimated fuel expenses had they not traded derivatives to hedge against rising prices.

	2011 (mil $)	**2010 (mil $)**	**Percent Change**
Fuel and Oil Expense, unhedged	$5,644	$3,448	63.7 %

AirTran Synergies

Internal reports estimate the acquisition of AirTran has the potential to yield net annual synergies of more than $400 million in 2013, excluding acquisition and integration costs. Without these acquisition and integration expenses, estimated to total approximately $500 million through 2014, the transaction was modestly beneficial to the Company's earnings in 2011, is expected to be so as well in 2012, and is expected to be strongly accretive thereafter, upon full realization of the estimated net synergies.[8]

Revenues

Operating revenues increased by $3.6 billion, or 29.4 percent, compared to 2010. The majority of the increase was attributable to the inclusion of the results of AirTran following the May 2, 2011 acquisition. Excluding the results of AirTran following the acquisition, operating revenues for 2011 increased by $1.6 billion, or 12.8 percent, compared to 2010, primarily due to a $1.5 billion, or 13.1 percent, increase in passenger revenues. Much of this increase was attributable to the 5.5 percent increase in

Southwest's capacity, versus 2010, which can also be expected to grow through 2012. The remainder of the increase primarily was due to higher passenger yields, as fare increases were implemented in an attempt to buffer a portion of the impact of higher fuel costs. Bookings and revenue trends also remain strong for the first quarter of 2012.[9]

OPERATING REVENUES	2011 (mil $)	2010 (mil $)	Percentage Change	Percent Change (excluding AirTran)
Passenger	14,735	11,489	28.2 %	13.1 %
Freight	139	125	11.2 %	11.2 %
Other	785	490	60 %	6.7 %
TOTAL	15,658	12,104	29.3 %	12.8 %

CASM

Southwest's 2010 CASM (cost per available seat mile) increased 9.7 percent compared to 2009. CASM is a key comparative metric of operating expenses in the airline industry. Over 55 percent of Southwest's year-over-year CASM increase was due to an 18.4 percent increase in average jet fuel cost per gallon. The 2009 operating expenses also included the impact of Freedom '09, an early retirement plan, which resulted in a $66 million charge. Excluding the impact of this charge, 2010 integration costs incurred in preparation for the acquisition of AirTran, and Fuel and oil expense for each year, 2010 CASM increased compared to 2009 primarily due to higher wage rates, higher profit sharing expense, and higher airport costs.

COST PER AVERAGE SEAT MILE (CASM)
(NON-REGIONAL CARRIERS ONLY)

3Q 2011 Rank	Airlines	3Q 2010	4Q 2010	1Q 2011	2Q 2011	3Q 2011	3Q Operating Expenses $(Millions)
1	Spirit	8.3	9.0	9.4	9.9	10.1	244
2	Virgin America	9.3	10.0	10.7	11.1	10.7	274
3	JetBlue	9.7	10.3	11.4	11.3	11.0	1,088
4	Allegiant	8.9	9.9	10.3	11.6	11.2	172
5	AirTran	9.8	11.0	12.2	12.4	11.5	741

6	**Southwest**	**11.1**	**11.7**	**12.2**	**12.6**	**12.5**	**3,346**
7	Alaska	11.7	12.4	14.4	14.6	14.1	976
8	Frontier	11.1	15.0	16.2	16.5	15.1	480
9	Continental	13.6	14.9	14.7	15.2	15.3	4,012
10	American	13.9	14.6	15.3	15.9	15.9	6,361
11	Delta	14.1	15.1	16.2	16.4	16.3	8,979
12	United	14.9	16.0	16.5	16.7	16.6	5,279
13	US Airways	15.4	16.4	17.9	17.8	17.5	3,333

From Bureau of Transportation Statistics (BTS)[10]

Industry Comparison

Below are some comparative metrics between Southwest Airlines and their biggest rivals in the airlines industry. Though they have lower profit margins than some of the smaller airlines, such as Spirit and Alaska, among the largest airlines they are only outperformed by Delta. Southwest's current market capitalization stands at $6.43 billion, third largest in the industry behind Delta and United Continental. [11]

	Market Cap. (bil $)	**Revenue, 2011 (mil $)**	**Net Income, 2011 (mil $)**	**Net Profit Margin**	**Operating Margin**
Alaska (ALK)	2.56	1044	64	6.13 %	10.93 %
Delta (DAL)	8.73	8,399	425	5.06 %	8.29 %
JetBlue (JBLU)	1.38	1146	23	2.01 %	7.24 %
Southwest (LUV)	**6.34**	**4,108**	**152**	**3.70** %	**3.58** %
Spirit (SAVE)	1.43	273	24	8.76 %	13.88 %
United Continental (UAL)	7.31	8,928	-138	-1.55 %	0.50 %
US Airways (LCC)	1.25	3155	18	0.57 %	3.42 %

	S&P Credit Rating[12]	**Return on Assets**	**Total Debt / Equity Ratio**	**Price / Equity Ratio**	**Earnings per Share**
Alaska (ALK)	B+	4.91 %	-	10.24	1.01
Delta (DAL)	B	3.94 %	705.15	11.70	1.88
JetBlue (JBLU)	B-	1.32 %	54.54	35.67	0.23
Southwest (LUV)	**BBB**	**3.39** %	**111.40**	**10.81**	**3.34**
Spirit (SAVE)	-	13.11 %	0.00	17.23	1.23
United Continental (UAL)	-	-1.44 %	178.49	18.10	0.27
US Airways (LCC)	B-	0.87 %	3,044.00	25.11	0.31

Stock Performance

Over the past five years, the Southwest's stock has performed very similarly to the AMEX Airline Index, an equally weighted composite of the world's largest companies in the airline industry. However, Southwest has dropped off in recent months, as seen in the 6 and 12 month graphs. The S&P 500 outperformed both Southwest and the Airline Composite over both 12 months and 5 years. Southwest's recent dip is likely attributable to lower than expected earnings over 2011. Most analysts seem to agree that that the stock is undervalued and that Southwest is well-poised for growth in 2012.[13]

STOCK PERFORMANCE COMPARED TO S&P 500 (RED) & AMEX AIRLINE COMPOSITE (GREEN)[14]

6 MONTH

12 MONTH

5 Year

Week of Mar 26, 2012: LUV 8.24 ^GSPC 1408.47 ^XAL 37.74
10%
0%
-10%
-20%
-30%
-40%
-50%
-60%
-70%
2007
Oct
2008
Apr
Jul
Oct
2009
Apr
Jul
Oct
2010
Apr
Jul
Oct
2011
Apr
Jul
Oct
2012

Competitive Analysis

The U.S. airline industry is extremely competitive and highly volatile. The industry is also cyclical, capital and technology intensive, heavily taxed, and heavily regulated, combining for very low profit margins for domestic airlines. Costs have been rising significantly across the industry in recent years and over the past decade, the total financial losses exceeded $50 billion. The increasing cost of fuel has been the primary source of rising costs for the industry, and its volatility makes hedging often inefficient. Fuel costs have risen over 300 percent since 2000.[15] Some airlines have been unable to cope with these rising costs, as evidenced by American Airlines' recent bankruptcy (though significantly affected by high labor costs) and United's acquisition of Continental. Within the industry, Southwest operates as a low-cost carrier, focusing on profitable point-to-point routes and good customer service. As a result, they operate fewer long-haul routes and tend to avoid some of the more congested airports.

Relevant Statistics from Domestic Airline Industry

	Domestic Passengers (millions)		Available Seat-Miles (millions)	
	2010	**2011**	**2010**	**2011**
Alaska (ALK)	14,880	15,982	22,065	23,804
Delta (DAL)	89,951	92,710	108,968	108,123
JetBlue (JBLU)	21,129	22,924	29,569	31,540
Southwest (LUV)[16]	**106,227**	**110,586**	**98,444**	**103,810**
Spirit (SAVE)	5,523	6,973	6,575	7,809
United Continental (UAL)[17]	73,912	70,707	113,621	110,608
US Airways (LCC)	45,140	46,170	52,127	52,475

From U.S. Bureau of Transportation Statistics[18]

Rivalry

The extent to which rivalry exists is important to analyze as it will influence the overall profitability of the entire industry. Market concentration is the critical factor affecting rivalry. The airline industry saw an influx of new entrants following the Airline

Deregulation Act of 1978, but since 1989 a trend towards consolidation has emerged. In 2004 the ten largest carriers retained a total market share of over 90%[19]. This concentration has only increased since then as more airlines consolidate and take advantage of economies of scale; the most recent being Southwest's acquisition of AirTran and the merger between Continental Airlines and United Airlines.

The intense competition within the industry coupled with sellers offering a product with very little differentiation has led to very low profit margins across the industry as airlines use price competition as their primary mode of rivalry. Differentiation might be possible as airlines begin to single out particular sectors of the market to focus their efforts. Southwest has already begun doing this as they focus primarily on low budget, no hassle travelers. Other than these minor shifts in focus, however, there are hardly any essential differences between the products airlines are putting out. In addition, their methods of incentives through frequent flyer programs are employed across the industry and afford little actual customer loyalty.

Entry and Exit

Although the profit margins have been low for airline companies quite a few new companies have attempted to enter the market in recent years. Due to significant barriers to entry, however, the majority of these forays have ended in failures. The one notable exception is JetBlue, which started in 2000 and has seen sizeable profit margins and high load factors. The rest of the fledgling airlines have been forced to cease operations due to the strong barriers to entry.

An intuitive barrier is the high startup costs faced by an emerging airline. Prior to the economic downturn, though, it was actually not difficult to secure a loan in order to lease a fleet of planes and enter the market. In more recent years, however, as lending has become much more conservative, it has become increasingly difficult for emerging airlines to finance the procurement of aircrafts, causing many to cease operations or declare bankruptcy. Another logistical barrier is the intense regulations that airlines have to adhere to in order to begin operations. The airline has to receive approval from the FAA and set up ground crews and personnel at their target airports before any planes can get off the ground.

The most significant barrier to entry is the intense post-entry competition newcomers face from existing major airlines. The strategy most newcomers pursue is to enter in to regional markets which offer the most profitable routes. Being young airlines the entrants have lower marginal costs since they have lower labor and maintenance costs allowing them to offer lower prices on these routes than existing carriers. However, the fierce price competition between preexisting airlines serves as a very strong incentive for them to maintain their market share. Thus, when a new entrant competes with a major airline on a route the incumbent will lower the prices on that route below those of the entrant while maintaining its higher fares on its non-competing routes. This strategy allows the major airlines to utilize their expansive array of routes to force out any potential competitors.

With the current conservative lending market conditions and the steep experience curve it would take a number of years for a new airline to become a credible competitor to any major airline.

SUBSTITUTES/COMPLEMENTS

Substitutes to air travel are mainly car, bus, and train transportation. Automobile travel dominates short distance travel because of the impracticality of flying short distances. As distances increase air travel begins to dominate, as trips of extended distances are impractical by car. Another increasingly popular substitute is intercity railroad transportation. Trains have several disadvantages, mainly increased travel time, but they have a distinct cost advantage when compared to air travel. As air travel gets more expensive, from higher fuel prices and increased baggage fees, train transportation becomes a more viable substitute. In addition, there has been a push from the White House in recent years to upgrade the rail system and put more of an emphasis on high-speed rail which could make train travel a more worrisome substitute in the future, but as of now they cannot be considered a direct substitute for the airline industry.

There are many complements to airline travel including hotels and rental cars. There has been increased cooperation between airlines, hotels, and rental car companies that have enabled airlines to bundle products to provide discounted travel packages. Oftentimes, though, travelers shun these packages finding that they can get cheaper rates purchasing a mixed array of these services separately from individual vendors. Southwest has attempted to integrate their reservation system with these deals by linking appealing schedules and packages allowing their customers to conveniently make reservations and scan all their options directly from the Southwest website. Ultimately, though, the price of these complements will only potentially have an effect on the leisure traveler as the business traveler has a much more inelastic demand.

SUPPLIER POWER

The primary inputs with some bargaining power are jet-fuel, airplanes, and labor. Jet-fuel suppliers have become the greatest source of increased supplier power in recent years. Although not perfectly correlated with crude oil prices, jet fuel prices have been significantly affected by the historically high oil prices of recent years. In addition, the "crack spreads" have further worsened the position of the airline industry to its jet-fuel suppliers. A crack spread measures the difference between the cost of a barrel of crude and a barrel of jet-fuel, and this spread has increased dramatically in recent years. While many airlines have accepted being subject to fluctuating fuel prices, Southwest adopted a dynamic hedging strategy allowing them to use hedging to create a cap on higher prices in the future. This generally results in net losses, but protects them from a sharp upswing in fuel prices. Their estimated exposure to varying fuel prices is outlined in the table below.

FUEL PRICE EXPOSURE[20]

Average WTI Crude Oil price per barrel	Estimated difference in economic jet fuel price per gallon, above/(below) market prices, including taxes		
	Q1 2012	Q2 2012	Q3 & Q4 2012
$75	$0.12	$0.12	$0.15
$90	$0.12	$0.09	$0.11

$99	$0.12	$0.06	$0.06
$115	$0.12	$0.06	($0.11)
$130	$0.11	$0.09	($0.28)
Estimated Premium Costs	$6 million	$5 million	$37 million

Airplane manufacturers have high bargaining power due to the large switching costs associated with changing airplanes. Since the only major players in the airplane manufacturing field are Boeing and increasingly Airbus, they can get away with charging slightly higher prices than would be possible in a perfectly competitive environment. With the current weakened state of the airline industry, however, this relationship has shifted. Southwest is the largest single purchaser of Boeing 737s, which makes it appear completely reliant on Boeing. With the depressed industry, though, and Southwest's plans to continue growing their fleet, Boeing may actually be becoming increasingly reliant on Southwest's continued business in the future.

Labor costs are the single largest expense in the airline industry, buoyed by numerous unions garnering premium wages and benefits for airline employees. The recent wave of bankruptcies from airlines, however, has led to a changing landscape as the airlines cancel their pension plans and pass on the obligation to the Pension Benefit Guaranty Corp. The fear of further pension cancellations and bankruptcies has resulted in a diminished supplier power for the unions as more concessions are made concerning employee compensation.

BUYER POWER

Buyers have very little power, as there is still no substantial substitute for air travel. Also, with the competition on price in the industry the airlines are already have very low profit margins so there is not much room for buyers to push the price lower even if they had power. The lack of buyer power has been highlighted by the continued onset of add on fees throughout the industry despite widespread consumer satisfaction.

SWOT ANALYSIS

Strengths	Weaknesses

- Point-to-point routing
- Boeing 737s
- Customer service
- Successful marketing
	- Growth into congested markets
	- AirTran integration
	    o Boeing 717s
	    o Labor relations

Opportunities	**Threats**
- Near-international destinations - In-flight WIFI and live sports - Growth from AirTran	- Fuel price volatility - Diminishing advantage as low-cost carrier - Regulation - U.S. economic condition

STRENGTHS

Southwest has traditionally been a low-cost carrier, which is how they were able to establish a foothold in the market. They tend to operate point-to-point routes, rather than the traditional hub-and-spoke strategy of the legacy airlines, which allows more flexibility in selecting profitable routes. Furthermore, they tend to rely on secondary airports in larger cities, such as Midway (rather than O'Hare in Chicago) and LaGuardia (rather than JFK in New York) to improve on-time reliability, an important aspect of customer relations.

Southwest has always aimed for 20 minute turnarounds at the gate – another perennial feature of its touted customer service – which is facilitated by its use almost exclusively of Boeing 737-700 planes. This allows for standardize maintenance procedures, and in general faster service. They have also historically had very good customer relations[21]. This has been aided by successful marketing campaigns, such as "Bags Fly Free", where Southwest drew attention to a point of differentiation from nearly all their competitors: a passenger's first and second checked bags are both free. This strong customer reputation has been instrumental in their continued growth.

WEAKNESSES

Southwest's rapid growth has proved problematic in maintaining the reliable service they have always touted. In 2010, their on-time arrival percentage dipped below 80% for the first time in company history to 79.5% (though was still higher than all of their major competitors), but has since risen back to 83.5% in 2011 [22]. With the integration of AirTran, Southwest's network will grow almost 20%, begging the question of whether this will further worsen their service. Additionally, AirTran's fleet consists of 88 Boeing 717-200s (in addition to a number of 737s), which pose new challenges for Southwest's operations, since they did not previously operated planes other than the various 737s[23]. AirTran also brings a number of congested markets, such as Atlanta, to Southwest's operations, which pose both opportunities for growth and potential challenges. There are also always possible challenges when expanding operations internationally, such as compliance with international laws. The integration of AirTran poses a number of other possible weaknesses as well. Though all has been smooth thus far, the integration of the various airline unions (Pilots, Maintenance, etc.) could pose problems to a smooth transition.

Any combination of these factors could force Southwest to revise its low-cost strategy.

OPPORTUNITIES

The AirTran acquisition allows Southwest near-immediate expansion in key markets, such as Boston and Baltimore, while diversifying their routes as well, with new destinations such as Atlanta. It also provides Southwest access to slot-controlled markets such as New York LaGuardia and Ronald Reagan Washington in D.C., where they previously had little or no presence.

In addition, with the acquisition of AirTran, Southwest is poised to begin operating in near-international destinations, such as the Caribbean and parts of Mexico. AirTran ended 2011 serving 68 U.S. and near-international destinations, and Southwest will continue these routes through the integration process. With the completion of their reservation system overhaul expected in the next year, Southwest can begin considering these routes. They are currently involved in litigation to internationalize Hobby Airport in Houston, where they have dedicated much infrastructure investment and hold a significant presence, which would facilitate their move into these new markets[24].

Further opportunities involved varied methods of generating additional revenue, such as by adding in-flight WiFi (wireless internet) through the provider Row 44. All flights equipped with the service charge $5, regardless of duration. As of February 2012, 165 of the fleet's 610 Boeing 737s had been equipped with WiFi, with the remainder hoping to be completed by the end of 2012. Row 44 recently signed deals with the NFL and MLB to offer live football and baseball games during flights[25].

Threats

There are a number of potential threats to Southwest's success in the highly competitive American airline industry. If they are unable to compete as they grow into busier, more congested markets, or internationally, Southwest will witness diminishing growth. Additionally, as many legacy carriers enter bankruptcy or realign themselves, Southwest loses some its supply advantages, most notably in labor costs. Southwest has been seeing increasing operating costs over the past few years, which if unchecked or allowed to grow faster than the competition, could force higher prices, and diminish market share.

There are also a number of industry-wide threats that could impact Southwest's profit margin. Any new regulation – via aviation or environmentally – would hurt Southwest's pricing ability. Furthermore, since air travel is fairly elastic, in times of economic downturn both leisure and business air travel decrease substantially. As such, the whole industry suffered through late 2008 and 2009, and another dip into recession would hurt Southwest's operations.

And as always, Southwest's exposure to fuel costs is a major weakness. Fuel prices are notoriously volatile, especially with the jet fuel price fluctuating sometimes independently from the crude oil price. The airline as a whole is vulnerable to these swings, on the positive side, but it still negatively affects Southwest's bottom line. Last year, fuel constituted 38% of Southwest's operating costs. Thus, despite the hedging Southwest actively engages in, any serious upswing still has negative ramifications.

STRATEGIC RECOMMENDATIONS

FURTHER DEVELOP ANCILLARY FEES

Southwest does not charge for the first two checked bags, which it has heavily promoted through the "Bags Fly Free" program. This has served them well, allowing Southwest to distinguish itself from the rest of the industry, even many low-cost carriers (LCCs). This can be seen in the chart below, where even Spirit Airlines, who handles 20 times fewer customers than Southwest, collects more in baggage fees.

BAGGAGE FEE REVENUE ($ MILLIONS)

3Q 2011 Rank	Airline	3Q 2010	4Q 2010	1Q 2011	2Q 2011	3Q 2011	Percent Change 3Q 2010 – 3Q 2011
1	Delta	259.5	219.1	198.0	226.3	232.5	-10.4
2	American	151.2	148.9	137.2	156.1	152.8	1.1
3	US Airways	131.8	125.5	120.9	134.8	128.8	-2.3
4	Continental	90.5	83.5	76.3	91.3	94.3	4.2
5	United	83.9	73.4	66.2	71.1	74.8	-10.8
6	Alaska	34.4	28.0	36.2	40.3	46.1	34.0
7	AirTran	38.1	39.8	39.3	46.1	42.8	12.3
8	Spirit	22.9	25.7	28.2	34.4	36.9	61.1
9	Frontier	14.7	18.0	16.7	18.0	20.2	37.4
10	JetBlue	15.5	13.7	14.3	15.9	17.4	12.3

From Bureau of Transportation Statistics (BTS)[26]

Similar data exist for Southwest's collection of reservation change fees, where again it doesn't crack the top ten, outpaced by small carriers such as Spirit. This allows Southwest to market themselves as customer-friendly and straightforward with their pricing.

RESERVATION CHANGE FEE COLLECTIONS ($ MILLIONS)

3Q 2011 Rank	Airline	3Q 2010	4Q 2010	1Q 2011	2Q 2011	3Q 2011	Percent Change 3Q 2010 - 3Q 2011
1	Delta	183.3	168.2	190.6	201.4	195.8	6.8
2	American	117.7	118.3	123.4	126.6	123.7	5.1
3	United	84.7	78.5	84.0	80.8	85.1	0.5
4	US Airways	63.6	61.2	70.8	71.9	68.7	8.0
5	Continental	61.0	56.4	59.9	61.1	59.9	-1.8
6	JetBlue	29.0	29.3	30.3	30.9	31.2	7.6
7	AirTran	11.9	12.1	11.7	13.5	13.2	10.9
8	Spirit	5.6	6.5	6.1	6.3	6.6	17.9
9	Virgin America	4.4	4.8	5.1	5.1	5.7	29.5
10	Frontier	4.1	4.6	5.7	6.3	4.5	9.8

From Bureau of Transportation Statistics (BTS)[27]

However, that is not to say Southwest does not collect fees to supplement its standard ticket revenue. In fact, the table below shows that Southwest collects more in supplementary (ancillary) revenue than any of its LCC competitors, and is outperformed by only three legacy carriers. These revenues largely come from optional ticket add-ons, such as auto check-in, allowing Southwest's reputation as "hassle-free" to remain unblemished. So long as they are able to maintain a profit margin with these secondary revenues, they are best off keeping the checked baggage free, since it is the most visible fee. As costs rise though (as examined on page 8), Southwest would do well to increase their collection of ancillary fees. As is, they collect fewer fees per passenger than the three other largest carriers. By expanding this source of revenue, Southwest could maintain the low ticket prices that have been such a major point of marketing and differentiation from their legacy carrier competitors.

ANCILLARY REVENUE ($ MILLIONS) [28]

3Q 2011 Rank	Airline	3Q 2010	4Q 2010	1Q 2011	2Q 2011	3Q 2011	Percent Change 3Q 2010 - 3Q 2011
1	Delta	693.1	627.7	658.6	691.3	814.3	17.5
2	American	291.8	286.5	277.7	303.4	300.2	2.9
3	US Airways	249.0	234.1	238.5	253.9	245.1	-1.6
4	**Southwest**	**212.7**	**224.0**	**212.6**	**223.5**	**232.0**	**9.1**
5	United	180.1	161.7	160.8	165.1	173.5	-3.7
6	Continental	160.5	146.9	144.8	162.2	162.9	1.5
7	AirTran	64.3	68.1	64.3	75.6	98.7	53.5
8	Spirit	55.3	67.8	67.2	82.0	89.8	62.4
9	Alaska	56.6	48.3	63.3	65.5	74.5	31.6
10	JetBlue	49.3	47.2	48.4	51.8	54.1	9.7

From Bureau of Transportation Statistics (BTS)[29]

INCREASE CARRYING CAPACITY

As a general trend, and expedited by their acquisition of AirTran, Southwest has been moving into more congested and more expensive airports. In order to maintain their relatively low operating costs (generally measured across the industry by cost per average seat-mile, or CASM) they must either raise prices or make the flights more profitable. Southwest's board has already approved the purchase of 73 Boeing 737-800s to be delivered between the first quarter of 2012 and year end 2017[30], thus allowing an increased capacity on certain flights. Griffin recommends expanding this order, and expediting delivery if possible. Since slots at these larger, more congested airports have fixed costs regardless of plane size, operating larger aircraft can be more profitable if the demand can sustain it.

By implementing the larger 737-800s in their fleet, Southwest also improves the profitability of long-haul flights. At present, Southwest offers some, but still relatively few long-haul flights. By expanding capacity, they can add longer routes at similar levels of profitability to shorter ones. With larger planes, the marginal expense of additional customers is reduced while they bring in the same revenue, allowing for more profitability. The risk here is that the demand must be sustainable so as to consistently fill the larger planes, or operating losses on these flights are likely. These 737-800s would allow for the continued growth they desire, without necessarily entering the most congested markets, or at least only in limited slots.

ADD NEAR-INTERNATIONAL DESTINATIONS

The larger planes described above also allow for more flexibility with routes over water, such as the recently added Caribbean destinations. These near-international destinations offer significant growth opportunities for Southwest if they can maintain the same low-cost structure that has made them so successful. AirTran already has access to some of these markets, which should help Southwest transition to full service. Southwest is also in the process of revamping the technology behind their reservation system so as to facilitate reservation to international locations.

Furthermore, aside from regulatory issues, Canadian markets could be accessible and profitable much as many of Southwest's U.S. markets are. Finally, Southwest has had a codesharing agreement in Mexico with Volaris since 2008. This has allowed them to assess the feasibility and market demand for a number of markets, and if the regulation and infrastructure costs are not prohibitive, Mexico could be another source of serious growth, in addition to the already developing Caribbean service.

EXPAND FUEL EFFICIENT FLEET

Another method of improving their CASM is by reducing the dependence on fuel. As seen above, fuel is the most significant contributor to their operating costs. As such, any reduction would help their operating margin. Boeing in recent years has been developing lighter and more fuel efficient planes, such as the 737 MAX and the Next-Generation 737. Southwest will be the first customer of the 737 MAX, and has ordered 150 with the first to be delivered in 2017[31]. The Next-Generation 737 is a more immediate modernization solution, as Southwest continues replacing older aircraft.

These new planes will also allow Southwest to phase out the Boeing 717s, which are essentially unnecessary in the point-to-point system they operate. Southwest must continue to be on the forefront of these developments, and though investing in the first of a technology carries an inherent risk, it is important that they take every opportunity to minimize fuel expenses and differentiate from the rest of the industry.

INTEGRATE AIRTRAN INTO THE POINT-TO-POINT STRATEGY

AirTran currently operates more of hub-and-spoke route strategy, wherein routes tend to connect through a centralized airport ("hub"), which for AirTran has been Atlanta. The need for smaller planes arises in these strategies, because often smaller flights are operated to shuttle passengers to the airline's hub. However, as Southwest now operates AirTran's flights, there are conflicting route strategies. In order to synchronize these differences and maintain their low-cost advantage, Southwest should enforce their point-to-point method onto AirTran's most popular destinations. The most significant of these is Atlanta, where Southwest had not serviced before (likely because of its congestion and role as Delta's hub).

As this integration occurs, Southwest will find reduced need for the smaller 717 aircraft, and can begin replacing them with the new, more efficient, Next-Generation 737 planes. This should reduce some of the increased temporary expenses for the AirTran merger, and allow Southwest to gain as much profit as possible from their most recent acquisition.

CONCLUSION

If Southwest is able to properly integrate AirTran into their method of operations, they will be well positioned for growth in 2012. Furthermore, by taking advantage of new fuel-efficient technologies, increasing the capacity of some long-haul flights, and expanding their discreet collection of ancillary fees, as Griffin Consulting Group has outlined, Southwest will continue to lead the airline industry for years to come.

APPENDIX

INCOME STATEMENT

Condensed Consolidated Statement of Operations (USD $) (In Millions, except Per Share data, unless otherwise specified)	12 Months Ended		
	Dec. 31, 2011	Dec. 31, 2010	Dec. 31, 2009
OPERATING REVENUES			
Passenger	$14,735	$11,489	$9,892
Freight	139	125	118
Other	784	490	340
Total operating revenues	15,658	12,104	10,350
OPERATING EXPENSES			
Salaries, wages, and benefits	4,371	3,704	3,468
Fuel and oil	5,644	3,620	3,044
Maintenance materials and repairs	955	751	719
Aircraft Rental	308	180	186
Landing fees and other rentals	959	807	718
Depreciation and amortization	715	628	616
Acquisition and integration	134	8	0
Other operating expenses	1,879	1,418	1,337
Total operating expenses	14,965	11,116	10,088
OPERATING INCOME (LOSS)	693	988	262
OTHER EXPENSES (INCOME)			
Interest expense	194	167	186
Capitalized interest	-12	-18	-21
Interest income	-10	-12	-13
Other Non-operating Income (Expense)	198	106	-54
Total other expenses	370	243	98
INCOME (LOSS) BEFORE INCOME TAXES	323	745	164
PROVISION (BENEFIT) FOR INCOME TAXES	145	286	65
Net income (loss)	$178	$459	$99
Net income per share, basic	$0.23	$0.62	$0.13
Net income per share, diluted	$0.23	$0.61	$0.13
Cash dividends declared per common share (in dollars per share)	$0.02	$0.02	$0.02

BALANCE SHEET

Condensed Consolidated Balance Sheet (USD $) In Millions, unless otherwise specified	Dec. 31, 2011	Dec. 31, 2010
Current assets		
Cash and Cash Equivalents, at Carrying Value	$829	$1,261
Short-term Investments	2,315	2,277
Accounts and other receivables	299	195
Inventories of parts and supplies, at cost	401	243
Deferred income taxes	263	214
Prepaid expenses and other current assets	238	89
TOTAL CURRENT ASSETS	4,345	4,279
Property and equipment, at cost		
Flight equipment	15,542	13,991
Ground property and equipment	2,423	2,122
Deposits on flight equipment purchase contracts	456	230
Property and equipment, at cost	18,421	16,343
Less allowance for depreciation and amortization	6,294	5,765
Property and equipment, net	12,127	10,578
Goodwill	970	0
Other assets	626	606
TOTAL ASSETS	18,068	15,463
Current liabilities		
Accounts payable	1,057	739
Accrued liabilities	996	863
Air traffic liability	1,836	1,198
Current maturities of long-term debt	644	505
Total current liabilities	4,533	3,305
Current maturities of long-term debt	3,107	2,875
Deferred income taxes	2,566	2,493
Deferred gain from sale leaseback transactions	75	88
Other non-current liabilities	910	465
Stockholders' equity		
Common stock	808	808
Capital in excess of par value	1,222	1,183
Retained earnings	5,395	5,399
Accumulated other comprehensive income (loss)	-224	-262
Treasury stock, at cost	-324	-891
Total stockholders' equity	6,877	6,237
TOTAL LIABILITY AND STOCKHOLDERS' EQUITY	$18,068	$15,463

CASH FLOW

Condensed Consolidated Statement of Cash Flows (USD $) In Millions, unless otherwise specified	12 Months Ended		
	Dec. 31, 2011	Dec. 31, 2010	Dec. 31, 2009
CASH FLOWS FROM OPERATING ACTIVITIES			
Net Income	$178	$459	$99
Adjustments to reconcile net income (loss) to cash provided by operating activities			
Depreciation and amortization	715	628	616
(Gain) loss recognized in income on derivatives	-90	-139	-14
Deferred Income Taxes and Tax Credits	123	133	72
Amortization of deferred gains on sale and leaseback of aircraft	-13	-14	-12
Changes in certain assets and liabilities			
Increase (Decrease) in Accounts and Other Receivables	-26	-26	40
Increase (Decrease) in Other Current Assets	-196	-8	-27
Accounts payable and accrued liabilities	253	193	59
Air traffic liability	262	153	81
Cash collateral received from (provided to) derivative counterparties	-195	265	-90
Other, net	194	-361	133
Net cash provided by (used in) operating activities	1,385	1,561	985
CASH FLOWS FROM INVESTING ACTIVITIES			
Payments to acquire business, net of cash acquired	-35	0	0
Purchases of property and equipment, net	-968	-493	-585
Purchases of short-term investments	-5,362	-5,624	-6,106
Proceeds from sales of short-term investments	5,314	4,852	5,120
Other, net	0	0	2
Net cash provided by (used in) investing activities	-1,051	-1,265	-1,569

CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from issuance of long-term debt	0	0	455
Proceeds from credit line borrowing	0	0	83
Proceeds from sale leaseback transactions	0	0	381
Proceeds from Employee stock plans	39	55	20
Proceeds from termination of interest rate derivatives	76	0	0
Proceeds from Convertible Debt			0
Payments of long-term debt and capital lease obligations	-557	-155	-86
Payments of Convertible Debt	-81	0	
Payment of revolving credit facility	0	0	-400
Payment of credit line borrowing	0	-44	-97
Payments of cash dividends	-14	-13	-13
Repurchase of common stock	-225	0	0
Other, net	-4	8	-13
Net cash provided by (used in) financing activities	-766	-149	330
NET CHANGE IN CASH AND CASH EQUIVALENTS	-432	147	-254
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,261	1,114	1,368
CASH AND CASH EQUIVALENTS AT END OF PERIOD	829	1,261	1,114
CASH PAYMENTS FOR			
Interest, net of amount capitalized	185	135	152
Income taxes	13	274	5
Supplemental Cash Flow Disclosures			
Fair Value of common stock issued in connection with the business acquisition	523	0	0
Debt Conversion, Converted Instrument, Amount	$78	$0	$0

Tables from Southwest Airlines (LUV) 2011 Annual Report

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[4] "LUV" was chosen because of Southwest's beginnings at Dallas Love Field Airport.

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[27] http://www.bts.gov/press_releases/2012/bts011_12/html/bts011_12.html

[28] "Ancillary revenue" includes baggage fees, reservation change fees and miscellaneous operating revenue, including pet transportation, sale of frequent flyer award miles to airline business partners and standby passenger fees, as well as other on-board revenues.

[29] http://www.bts.gov/press_releases/2012/bts011_12/html/bts011_12.html

[30] Southwest 2011 Annual Report

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