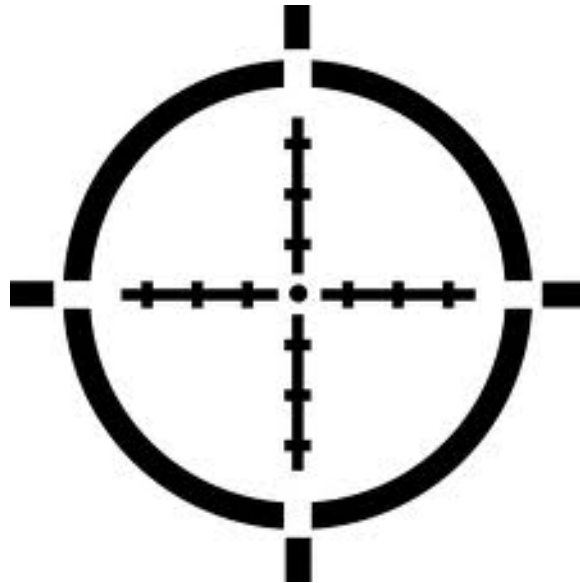
American Airlines

Client Report

DangerZone Consulting



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Contents

Executive Summary ... 3

Company Background ... 4

Financial Analysis ... 9
- Income Statements ... 9
- Balance Sheets ... 10
- Cash Flow ... 11

Competitive Analysis (Five Forces Framework) ... 12
- Internal Rivalry ... 12
- Buyer Power ... 13
- Supplier Power ... 14
- Threat of New Entrants ... 14
- Threat of Substitutes ... 15

SWOT Analysis ... 16
- Strengths ... 16
- Weaknesses ... 18
- Opportunities ... 20
- Threats ... 22

Strategic Recommendations ... 26

Executive Summary

DangerZone Consulting believes that the new American Airlines is poised for greatness, holding numerous advantages within the airline industry. However, recovering from shaky financial histories and navigating through complex integration processes will not be easy. Moving forward, our consultants have identified two key areas in which company management must succeed: Customer Relations and more directly, the Balance Sheet.

Specifically, American Airlines needs to convince passengers that they can provide the quality travel experiences that they promise, and capitalize on their strengthened networks and aircraft fleet, securing a healthy financial future.

American's success will ride on their ability to smoothly integrate their customer rewards programs, improve their on-time departure rates, recover customer service relations and capitalize on their newly expanded networks and fleets. By focusing on these objectives, American Airlines Group should be able to use their brand equity, customer loyalty, and the superior fuel efficiency of their newer aircraft to regain profitability and a competitive position within the market.

While merging separate operating systems, technologies, and cultures often generates unexpected complexities and integration costs, many profitable synergies are ripe for the picking, and analysts are optimistic. The potential success of the recent merger between American and US Airways knows no bounds - the sky is truly the limit.

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Company Background

In 1929, The Aviation Corporation was formed to acquire young aviation companies. One year later, these airline subsidiaries were incorporated into American Airways, Inc., which was renamed American Airlines, Inc. shortly afterwards. Cyrus Rowlett Smith was president/CEO of the company from 1934 to 1968, leaving the company only when he was named U.S. Secretary of Commerce. By 1940, American Airlines was the nation's leading domestic air carrier (in terms of revenue-passenger miles). On June 10, 1939 American Airlines began trading on the New York Stock Exchange.

A true pioneer within the industry, American's subsidiary Sky Chefs allowed them to enter into the airline catering business. Starting in 1942, they provided quick cuisine to both their own passengers as well as other airlines'. AA also introduced the air cargo industry's first scheduled airfreight service on October 15, 1944. During the1940s, American Airlines also introduced pricing schemes such as reduced Family Fare rates, and more affordable alternatives to first class travel: the coach, and business classes. Around 1950, their first trans-Atlantic division was developed, establishing some of the first European services; American Overseas Airlines (AOA) was formed through the merging of American's international division and American Export Airlines. AOA eventually merged with Pan American World Airways in 1950. American Airlines was also responsible for establishing the world's first unique facility to train their flight attendants: the American Airlines Stewardess College in Dallas/Fort Worth in 1957. American had an eye for identifying new service opportunities within the airline industry: nonstop transcontinental service, coast-to-coast jet service with the Boeing 707, and the introduction of the turbofan engine in 1961.

Moving into the 1960s, American Airlines established a partnership with IBM, allowing them to implement cutting edge technology: the SABRE system (semi-automated business research environment). At the time, this electronic data processing system was the most complex of its kind, second only to the U.S. government's SAGE system. The 1970s saw a merger with Trans Caribbean Airways and then continued expansion of routes and locations – expanding on hub and spoke networks to take advantage of scale economies. New CEO, Albert Casey, oversaw the

introduction of more automated check-in processes, and American's popular "Super Saver" fares. Deregulation of the airline industry in the late 1970s allowed for the continuation of major route expansion, and encouraged the entry of low service, cut-rate carriers within the industry.

Headquarters were relocated from New York to Dallas/Fort Worth in 1979 to accommodate their Learning Center, the Flight Academy, the pilot training facility, and the Southern reservations office. Robert Crandall, elected CEO in 1980, oversaw the retirement of the Boeing 707 fleet as a consequence of soaring fuel costs. Travel rewards programs were implemented as a revolutionary addition to their marketing program. In 1982, stockholders approved company reorganization and the AMR Corporation was formed as the holding/parent company of American Airlines, Inc. American Airlines had over 50,000 employees by 1986. More organizational changes included the sale of Sky Chef, and the acquisition of Air California. The popularization of personal computers led to huge advancements of the SABRE system.

During the 1990s, European and international routes were expanded and new maintenance facilities were established. In order to allow customers greater flexibility, simplicity and fairness, American Airlines introduced a Value Pricing system. However, intense price competition forced them to give up this program shortly after its institution. The holding company formed an airline industry-consulting subsidiary in 1993, a SABRE Technology Group, as well as a formalized risk assessment unit. Changes were made to facilitate group travel arrangements, including the launch of First Call. Not until 1997 was smoking onboard planes prohibited, and ticketless travel developed. 1998 was the year that a global alliance was formed between American and 4 other airlines - a customer driven commitment to raising the standard of air travel. Another advancement pioneered by American Airlines was their introduction of the in-flight video (DVD) amendment.

A project titled “More Room Throughout Coach & Business” was focused on improving customer comfort and the expansion of onboard legroom. This program was executed through plane modification and the removal of several rows of seating. Around this time, new terminals were being built in the JFK and Boston airports, and American oversaw the development of additional maintenance hubs. A gateway to Japan was established in 2002 through the JFK-

Tokyo route. In 2006, American Airlines celebrated having enrolled more than 50 million frequent flier members, and introduced its first Chinese service (Chicago to Shanghai). International expansion continued with the addition of new routes to Argentina, and Russia. The parent company divested from the American Eagle subsidiary in 2007-2008.

In 2008, American developed the Aircell Internet broadband connectivity solution, and introduced “Travel Bag,” a new application on the Facebook Platform, which sought to capitalize on the social media upswing. An option to purchase airline reservations with electronic checks increased ease and flexibility for online travel bookers. To further facilitate customers’ online experience, AA added connections with thousands of additional hotel properties. The sale of American Beacon Advisors was the loss of AMR's wholly owned asset-management subsidiary, but they continued to provide a number of services for years to come.

In 2009, American wrote a letter to Congress supporting the passage of the proposed Employment Non-Discrimination Act, taking a political stand for diversity and equality. In another attempt to simplify things for consumers and satisfy greener standards, AA continued to move toward paperless documentation, and expand mobile boarding pass availability. One-Way Flex Awards offered a whole new approach to frequent flyer reward travel, and created even greater value for AAdvantage members. The “Your Choice” program provided key services intended to make the passenger travel experience even more personalized, convenient, cost-effective and flexible than ever before. More recently, American Airlines received tentative approval from the United States Department of Transportation (DOT) for its trans-Atlantic antitrust immunity (ATI) request.[1]

Key historical events that paint a less favorable portrait of the company include the acquisition of low-cost Reno Air in 1998; pilots later conducted a costly sickout in protest. In 2001, American acquired the assets of bankrupt TWA. This was a deal that eventually left AA saddled with old planes and too many employees. American Airlines began losing money in the economic downturn that followed the terrorist attacks on September 11, in which two American Airlines and two United Airlines jets, were hijacked and destroyed. During this period, the company was

[1] American Airlines, 2011, *History of AMR and American Airlines*.

unsuccessful in attempts to renegotiate wages and benefits with workers; the relationship and trust between management and laborers began to disintegrate. In 2003, the company was on the brink of bankruptcy, and Gerard J. Arpey replaced Donald J. Carty as the CEO. Luckily, labor unions finally approved cost-cutting contracts that allowed AMR to narrowly avert bankruptcy. In 2009, trying to get the company's financials back on track, American announced a new "cornerstone" strategy: focusing on five big U.S. markets — Dallas-Fort Worth, Chicago, Miami, New York and Los Angeles — while downplaying others. Still, in 2010, AMR reported a loss of $471 million, bringing total losses since 2001 to more than $10 billion. The next July, endorsing the notion that one must spend money to make money, American placed the largest aircraft order in history. Finally, 2011 manifested the inevitable: AMR, American Airlines and other subsidiaries filed for bankruptcy protection on November 29th. The following day, Gerald Arpey retired and was replaced by Thomas W. Horton.

In August 2012, American Airlines and US Airways signed a nondisclosure agreement in which the companies would discuss their financials and a possible merger. Only after notifying 11,000 workers of possible job loss due to bankruptcy reorganization, announcing plans to hire 2,500 new pilots to staff new routes, and successfully ratifying a new agreement between the company and the Allied Pilots Association, did the companies announce their full intent to merge. In August of 2013, The Department of Justice, six state attorney generals and the District of Columbia filed a civil antitrust lawsuit to block the merger, saying it would lead to higher airfares. Despite the hopes of some that the merger between American Airlines and US Airways would be denied, the company increased their lobbying and was successful in overturning their injunction to merge.[2]

Legacy carrier American Airlines merged with US Airways in late 2013 creating the largest airline in the world. The new holding company, American Airlines Group, Inc. (AAL) was listed on NASDAQ after the completion of the merger on December 9, 2013. Despite the forward progress, the two airlines will remain somewhat distinct until full integration under a single operating certificate, with expected completion in late 2015.

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[2] Yahoo Finance, 2013, *A Timeline of Events in American Airlines' History*.

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The American Airlines-US Airways merger leaves four major carriers controlling more than 80% of the US air passenger market. Concerns that such an "anticompetitive" development within the industry would lead to higher ticketing prices and dwindling consumer choice, the United States Department of Justice filed a lawsuit in an attempt to block the merger in August of 2013. A settlement was eventually reached in mid-November, mandating that American and US Airways divest a handful of boarding gates, as well as takeoff and landing slots across their major hubs. As neither airline was dominant in the markets in which they were forced to make concessions, the settlement revealed the true objective of the antitrust regulators: boosting the fortunes of low-cost carriers, rather than protecting consumers.

The US Department of Justice further stipulated that the combined airline must carry the American Airlines name and branding for at least 5 years, even though former US Airways CEO, Doug Parker, will take the helm of American Airlines Group as Chief Executive Officer. In fact, most of the US Airways management team will retain their operational management positions. Headquarters are to be consolidated at American's campus in Fort Worth, Texas.

Hastening AMR's exit from bankruptcy, the milestone merger transaction boasts an estimated worth of $11 billion, and is projected to provide widespread synergistic benefits and cost savings. Negotiations between executive management resulted in the American Airlines (AMR) bondholders and shareholders retaining ownership of 72% of the company, while the US Airways shareholders own the remaining 28%.

The new behemoth operates more than 6,700 flights daily, to 336 locations in 56 countries across the globe. They rake in close to $40 billion in operating revenue annually, employ about 100,000 workers, and expect the delivery of around 600 new aircraft in the coming years.[3] American (AAL) shares are already up 48% this year, and according to Bloomberg data, of 15 analysts covering the company, 12 analysts rate it a "buy" and three call it a "hold." [4] Although they have officially embarked on their journey, it will still be many years until the two airlines are finally integrated as one carrier and operate as one brand.

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[3] American Airlines, 2013 Press Release, *Merger Transaction Completed*.
[4] Bloomberg, 2014, *American Record Profit Seen as Air Merger Buoys Industry*.

Financial Analysis

Income Statements

Metric	US Airways			American Airlines		
	Dec 2013	Dec 2012	Dec 2011	Dec 2013	Dec 2012	Dec 2011
Revenue	$14,607.00	$13,831.00	$13,055.00	$26,743.00	$24,855.00	$23,979.00
Cost of Goods Sold	$ 6,786.00	$ 7,323.00	$ 7,206.00	$ 9,099.00	$10,117.00	$ 9,588.00
Gross Profit	$ 7,821.00	$ 6,508.00	$ 5,849.00	$17,644.00	$14,738.00	$14,391.00
Gross Profit Margin (%)	54.00%	47.00%	45.00%	66.00%	59.00%	60.00%
SG&A Expense	$ 4,266.00	$ 4,153.00	$ 3,927.00	$11,864.00	$10,337.00	$10,727.00
SG&A Expense/Revenue	29.21%	30.03%	30.08%	44.36%	41.59%	44.73%
Depreciation & Amortization	$ 302.00	$ 245.00	$ 237.00	$ 853.00	$ 1,015.00	$ 1,086.00
Operating Income	$ 1,003.00	$ 856.00	$ 426.00	$ 1,399.00	$ 107.00	$ (1,054.00)
Operating Margin (%)	7.00%	6.00%	3.00%	5.00%	0.00%	-4.00%
Nonoperating Income	$ (26.00)	$ 122.00	$ (13.00)	$ (2,743.00)	$ (1,966.00)	$ (165.00)
Nonoperating Expenses	$ (346.00)	$ (341.00)	$ (323.00)	$ (836.00)	$ (586.00)	$ (760.00)
Total Net Income	$ 392.00	$ 637.00	$ 71.00	$ (1,834.00)	$ (1,876.00)	$ (1,979.00)

All numbers listed are in millions of US Dollars
Source: American Airlines, 2013 Annual Report.

The income statements of the two merging companies relate the same story we discussed earlier. We can see on the American Airlines income statement that the net income is extremely low, mostly due to the acquisition of a new fleet. This is evidenced in the larger but rapidly declining depreciation of American Airlines. More important than this, however, is the continuing operations losses that American was taking before the merger. US Airways can try to fill this hole with capital, but most of the factors creating this problem will likely be dealt with in the American bankruptcy restructuring. We can also see that American Airlines has much larger revenues, but that its SG&A expenses make up a much larger portion of that revenue than US Airways'. All of these things show a much larger but less efficient American Airlines. Interestingly, the Cost of Goods Sold of American Airlines is not much larger than that of US Airways given the huge revenue difference. This points to returns to scale in the industry, and shows part of the reason why US Airways and American Airlines have merged.

Balance Sheets

Metric	US Airways			American Airlines		
Total Assets ($, million)	**Dec 2013**	**Dec 2012**	**Dec 2011**	**Dec 2013**	**Dec 2012**	**Dec 2011**
Current Assets						
Cash	--	$2,276.00	$1,947.00	$ 1,140.00	$ 480.00	$ 283.00
Net Receivables	--	$ 298.00	$ 327.00	$ 1,560.00	$ 1,124.00	$ 902.00
Inventories Assets	--	$ 300.00	$ 235.00	$ 1,012.00	$ 580.00	$ 617.00
Other Current Assets	--	$ 708.00	$ 540.00	$10,611.00	$ 4,888.00	$ 4,955.00
Total Current Assets	--	$3,582.00	$3,049.00	$14,323.00	$ 7,072.00	$ 6,757.00
Net Fixed Assets	--	$4,704.00	$4,150.00	$19,259.00	$13,402.00	$14,306.00
Other Noncurrent Assets	--	$1,110.00	$1,136.00	$ 8,696.00	$ 3,036.00	$ 2,785.00
Total Assets ($, million)	--	$9,396.00	$8,335.00	$42,278.00	$23,510.00	$23,848.00
Liabilities	**Dec 2013**	**Dec 2012**	**Dec 2011**	**Dec 2013**	**Dec 2012**	**Dec 2011**
Current Liabilities						
Accounts Payable	--	$ 366.00	$ 386.00	$ 1,368.00	$ 1,244.00	$ 1,007.00
Short-Term Debt	--	$ 417.00	$ 436.00	$ 1,446.00	$ 1,419.00	$ 1,518.00
Other Current Liabilities	--	$2,520.00	$2,338.00	$10,992.00	$ 6,641.00	$ 6,105.00
Total Current Liabilities	--	$3,303.00	$3,160.00	$13,806.00	$ 9,304.00	$ 8,630.00
Long-Term Debt	--	$4,376.00	$4,130.00	$15,353.00	$ 7,116.00	$ 6,702.00
Other Noncurrent Liabilities	--	$ 927.00	$ 895.00	$15,850.00	$15,077.00	$15,627.00
Total Liabilities	--	$8,606.00	$8,185.00	$45,009.00	$31,497.00	$30,959.00

All numbers listed are in millions of US Dollars
Source: American Airlines, 2013 Annual Report.

US Airways has no information for 2013 because of the merger. This also explains why there is a dramatic increase in American's balance sheet. Interestingly, adding the two companies' assets in 2012 results in far less than American's assets in 2013, indicating that the combined American must have been able to grow significantly through the merger. This asset growth appears mostly to be in the "other current assets" category, indicating that there could be payments due from subsidiaries of these companies. What specifically these payments are, we cannot conjecture. Regardless, it is clear that the merged company balance sheet is much more balanced compared to American in 2012. We can see that the company has mostly long-term debt, which it will certainly be able to pay off with the improved efficiency of its fleet.

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Cash Flow

Metric	US Airways			American Airlines		
	Dec 2013	Dec 2012	Dec 2011	Dec 2013	Dec 2012	Dec 2011
Cash and Cash Equivalents at the Beginning of the Year	$2,276.00	$1,947.00	$1,859.00	$ 480.00	$ 283.00	$ 168.00
Net Cash Provided in Operating Activities	--	$1,017.00	$ 472.00	$ 675.00	$ 1,279.00	$ 680.00
Net Cash Provided by Investing Activities	--	$ (844.00)	$ (472.00)	$(3,814.00)	$(1,571.00)	$(1,292.00)
Net Cash Provided by Financing Activities	--	$ 156.00	$ 88.00	$ 3,799.00	$ 489.00	$ 727.00
Net Increase/Decrease in Cash and Cash Equivalents	--	$ 329.00	$ 88.00	$ 660.00	$ 197.00	$ 115.00
Cash and Cash Equivalents at the End of the Year	--	$2,276.00	$1,947.00	$ 1,140.00	$ 480.00	$ 283.00

All numbers listed are in millions of US Dollars
Source: American Airlines, 2013 Annual Report.

The reason that US Airways is still listed as having cash at the beginning of the year in 2013 is because this accounting date was before the merger with American. We can see that American at the end of 2013 has a huge deficit in net cash provided by investing activities. This is due to a large recent purchase of aircraft. In 2011, American made the largest commercial aircraft purchase in history, including 260 Airbus A320 aircraft and 200 Boeing 737s. The deal was worth more than $38 billion USD, and will be paid for using lease financing provided by Airbus and Boeing.[5] It is likely American will continue to see large deficits in net cash provided by investing activities for the foreseeable future while they continue to pay for the purchase of these planes. Fortunately, these planes will eventually pay for themselves in efficiency gains and the pricing advantage American will gain.

[5] American Airlines, 2013 Annual Report.

Competitive Analysis (Five Forces Framework)

Internal Rivalry

American Airlines faces intense competition within the industry. After recent consolidation, the top four major carriers – American Airlines, United Continental, Delta and Southwest now control over 70% of the domestic US market. The following table illustrates the industry's competitive landscape in terms of market share based on revenue passenger-miles.

Rank	Company	Market Share (%)
1	Delta	16.3
2	Southwest	15.7
3	United	15.6
4	American	12.7
5	US Airways	8.5
6	JetBlue	5.1
7	Alaska	4.1
8	ExpressJet	2.6
9	SkyWest	2.3
10	AirTran Corp	2.0
-	Other	15.1

Source: RITA Bureau of Transportation Statistics

Bankruptcy has always been a theme in the Airlines Industry; consolidation however, is a relatively recent trend. In 2008, Delta Airlines and Northwest Airlines Corp. merged with Delta remaining as the surviving entity. In 2011, Southwest, the largest domestic US airlines in terms of revenue passenger miles, acquired AirTran Holdings Inc., which significantly increased Southwest's presence in Atlanta. United Airlines completed its merger with Continental Airlines on October 31, 2010, creating a global airline with revenue of $37 billion in 2011. In December 2013, American Airlines and US Airways officially signed off on their merger, which created the world's largest airline (by revenue or revenue passenger miles).

The US airline industry now has fewer competitors, which should help the industry to be more disciplined on pricing and capacity - this provides the opportunity for the generation of more sustainable return on invested capital. The consolidation of American Airline and US Airways should allow AA to improve results both domestically and abroad, and ultimately, make the company a more powerful player in this industry.

The top major carriers also face stiff competition from smaller carriers such as Southwest, Virgin America and Sprint, which adopt a point-to-point model rather than hub-and-spoke. The smaller carriers only focus on existing "cash cow" routes and often times use secondary airports in major cities. The newer carriers have also cleverly chosen to use a single or very few models of airplanes, which substantially reduces pilot training and plane maintenance costs.

Bargaining Power of Suppliers

The suppliers of American Airlines include: fuel companies, aircraft manufacturers (Boeing and Airbus), labor, and air space.

Fuel & Aircraft

Fuel is a commodity traded in large quantity everyday in the market. There are many players in this market but no one single firm has influential power. No exception, American Airlines is a large fuel consumer but it is too small to have any bargaining power against the price that is set within the market.

Aircraft manufacturers have significant bargaining power against American Airlines and other airline companies. Since the large commercial jet airliner market is a duopoly between Boeing and Airbus, they are both essentially irreplaceable and non-manipulable. In the case of American Airlines, its current fleet consists predominantly of Boeing planes. However, the order book shows that the company is shifting more towards Airbus family jets.

Labor

Labor forces, especially pilots, at American Airlines have decent bargaining power. Most airline workers belong to one of a dozen major unions. The larger unions include the Association of

Flight Attendants, the Air Line Pilots Association, and the International Association of Machinists and Aerospace Workers. Pilots, cabin crew, ground personnel etc. have bargaining power mainly due to the labor agreements at the time of industry regulation that left them with little flexibility. Surveys have also shown that there is a global shortage of pilots because of the growing demand for flights to and from emerging market countries. American Airlines has significant international reach and is therefore impacted by this global trend in the long-term.

Air Space

Air space is part of sovereign territory. Airline companies have little power when it comes bargaining with governments. For example, recently the EU decided to impose a carbon tax on all airlines flying to and from all EU airports. We can expect to see more countries implementing similar policies in light of the popularity of environmental movements.

Bargaining Power of Buyers

On the one hand, the airline industry is a very competitive market. Customers often have many options to choose from when purchasing tickets on popular routes. Therefore it is extremely difficult for one airline company to change pricing. In the past year, there were 10 attempts at airfare hikes, of which only two were successful. Online ticketing has made airfares so transparent that it is extremely difficult, if not impossible, for single airlines to get away with fare hikes. Customers' collective shifting choices can force airlines to drop prices back to competitive levels and reverse attempts to raise prices. At the same time, however, each individual customer has little power to negotiate price with any one airline.

Threat of New Entrants

Threat of new entrants within the Airline industry is relatively low. There are significant barriers to entry including fixed investment, regulations and the complexity of operations. It requires substantial capital expenditure and investment to enter this market, due in large part to costly aircraft and infrastructure. Additionally, operating an airline requires significant government certification and licensure. Even for eligible players, entry is not a particularly appealing option - most airlines have been performing poorly in terms of profitability. Lastly, ports at major airports are scarce resources that are often locked into long-term contracts with existing airlines.

Exit from the industry can also present challenges. It is often hard to resell the planes at market value. In addition, airlines usually commit to long-term leases with airports and aircraft manufacturers, and terminating contracts early can be extremely costly.

Threat of Substitute Products

Substitutes for using commercial air travel include driving, taking trains, private jets, and using video-conferencing technology. The closest substitutes are driving (short distance) and riding express trains (short to long distance).

In the short term, the composition of different travel methods is expected to stay relatively stable. In the long term, with the absence of significant technological discovery, air travel is expected to rise globally given the growing demand and disposable income in the emerging market.

For wealthy individuals, flying private jets remains an attractive option. With private jets becoming more and more affordable, in the long-term airlines are expected to lose many of their high net worth customers to this more luxurious alternative. Passengers can purchase, lease, or commission private aircraft.

Lastly, the development of video-conferencing technology has reduced business demand for travel. Rather than taking a 6-hour flight from New York City to Los Angeles, businessmen can simply turn on their computer and have a virtual face-to-face conversation with clients. If better technology is to be developed to make video-conferencing even more lifelike, there exists the threat of a further decrease in business air travel.

SWOT Analysis

Strengths	Weaknesses
• Legacy Carrier & Brand Recognition • Modern Fleet Arriving • Last Mover Advantage & CEO Experience • Strengthened Pricing Stability	• Recovering from American's Past • Customer Service & On-Time Performance • Loss of Valuable Talent • Weak U.S.-Asia Network
Opportunities	**Threats**
• Merger Synergies • Ancillary Fees • Pricing Discounts & Promotional Fares • International Expansion	• Monetary Costs of Integration • Merger Risks • Limited Suppliers • Insurance • Route & Cost Competition

Strengths

Legacy Carrier & Brand Recognition

American Airlines is a well-established brand across the globe, and a legacy carrier that provides higher quality services than smaller low-cost competitors; for example, they offer different classes of seating, frequent-flyer programs and access to exclusive airport lounges.

The extensive media coverage on the recent merger between American Airlines and US Airways has reflected analysts' positive outlook; essentially functioning as a free marketing campaign, much of the public already seems convinced that American is making a comeback. The post-merger American also has the advantage of sheer size, now claiming the title of the world's largest airline as measured by fleet and available seat miles.

Modern Fleet Arriving

American expects the delivery of 460 single-aisle jets, 200 Boeing 737s, 42 Boeing 787-9 Dreamliners, and 260 Airbus A320s between 2013 and 2022 - the largest aircraft order in history. This will greatly benefit the company by providing superior fuel efficiency and cutting operating costs. In part due to the young US Airways fleet acquired during the merger, the newly consolidated American is set to have the youngest fleet in the industry by 2017.

The new fleet will also offer passengers new comforts. Airline representatives tell Boeing that the new Dreamliners are performing as expected, and that feedback from passengers has been very positive. Selling points include reduced noise and increased cabin pressure, which is said to alleviate many ill-effects of flying such as fatigue and dehydration. The lighter cabin also boasts bigger windows.

The Boeing 787, nicknamed the "hub buster," has the potential to rewrite traditional models of funneling and connecting passengers onto the jumbo jets that make long haul flying viable. Inside the cockpit, a more technologically advanced and streamlined cockpit reduces the complexity of takeoff and landing procedures - these advancements have the potential to counterbalance increased delays that often accompany mergers.[6]

Last Mover Advantage & CEO Experience

The late 1970s saw the deregulation of the airline industry. These changes facilitated the entry of many small low-cost airlines, which challenged the existing dozen major carriers. Industry expansion drove down prices, yet legacy carriers were locked into expensive aircraft, airport leases and union contracts. These struggles began the cycle of bankruptcies and mergers (most recently, Delta and Northwest, United and Continental), leaving 70% of the domestic market in the hands of the "Top Four." American has a last mover advantage as it wraps up the era of airline consolidation - executives have witnessed the unexpected integration costs and complexities that caught first-movers off-guard.

CEO Doug Parker also has personal experience with mergers under his belt. Parker achieved over $1-2 billion in cost savings when he merged America West with then-struggling US Airways. (Under CEO Bruce Lakefield, US Airways had filed for bankruptcy twice in two years.)

Many of pre-merger American's struggles stemmed from poor management-labor relations, which prevented the airline from reaching its potential. Parker believes that one of the biggest

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[6] The Guardian, 2013, *Battle for the future of the skies*.

opportunities in the American overhaul is changing the company's mindset; he was smart enough to involve labor unions, flight attendants, and pilots early on in the negotiation process in order to secure the support of employees and creditor committees. Moving forward, the executive management teams have learned from previous bankruptcies, and following Chapter 11 guidelines, have restructured to eliminate excess costs and improve capacity discipline.[7]

Strengthened Pricing Stability

The market dominance of the "Final Four" airlines will make it much more difficult, if not impossible for startup airlines to enter and compete within the industry. This reduces the likelihood that new and inconsistent low-cost structures will disrupt the traditional pricing schemes of legacy carriers.

American also has renewed potential to operate at full capacity, and seems to be capitalizing on the increasing demand associated with economic recovery - this provides further opportunity for fare hikes. Should fare premiums become a necessary tool to compensate for higher fuel costs, the consolidation should help higher prices stick. American is also sitting on a hefty sum of cash, which, barring Chapter 11 restrictions could provide means for buybacks and dividends.[8]

Weaknesses

Recovering from American's Past

American Airlines has faced many financial challenges in recent years. In addition to the obvious bankruptcy struggles, American has suffered from lower revenue per available seat mile than even many of the smallest airlines.

Pre-merger, management-labor relations at American were all but non-existent. The initial steps in the merger have produced a boost in morale and optimistic contract negotiation; however, the new American has years of unsettled compensation yet to reconcile.

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[7] Dallas News, 2013, *Goodbye, AMR and US Airways Group, Hello American Airlines Group and its new Management Team.*

[8] Bloomberg Businessweek, 2014, *American Airlines Reports It's Holding $10 Billion in Cash.*

Customer Service and On-Time Performance

American Airlines claims that they are committed to providing consistent, safe and convenient service to their customers at every point of operation. However, their only true consistency pre-merger seemed to be weak on-time performance and maintaining a very low rating in customer service evaluations. Further, management refused to take responsibility for the inefficiencies, blaming the recent negative trends on more severe summer weather conditions.

American Airlines reports that in 2013, on-time performance was at 77.6%, up from 76.9% in 2012, mishandled baggage increased from 2.92 to 3.02 (per 1,000 passengers), and customer complaints also increased from 1.80 to 1.99 (per 100,000 passengers). Large airline mergers in recent years have proven to negatively impact all three measures of service, at least temporarily. American Airlines should learn from their peers' trials and tribulations - they must take preventative measures.[9]

American Airlines is not alone in its struggle with customer service, and the second largest U.S. carrier, United, has also landed in the top four for customer complaints since 2011. Both companies should take cues from Delta, who successfully decreased complaints from 1.93 to 0.59 (per 100,000 passengers) since 2009. Analysts suggest that Delta passengers were pleased with the ability of improved management and operating systems to keep flights running on-time, newly renovated terminals, and expanded entertainment and food options.[10]

Loss of Valuable Talent

Previous American Airlines CEO Tom Horton successfully completed Chapter 11 restructuring, and made massive company improvements in the year prior to the merger. Horton responsibly secured new contracts from unions and increased revenues. He was very dedicated and personally invested in turning the company around. The company stands to lose momentum as he transitions into the position of Chairman. Ultimately, however, most analysts and insiders believe a fresh start with Parker was what the company needed.[11]

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[9] American Airlines, 2013 Annual Report.

[10] Reuters, 2014, *Biggest U.S. Airlines Among Worst in Customer Service*.

[11] Skift, 2013, *The New American Airlines.*

Weak Network in Asia

Prior to the merger, revenues from international operations made up 40% of American Airlines' total operating revenue, and only 24% of US Airways'. This put both carriers at a severe disadvantage compared with other larger carriers, specifically Delta and United, which boasted 48% and 49% of total revenues from foreign operations, respectively.

While American worked through Chapter 11 restructuring, it continued to reinforce its strong Latin American network, particularly in Brazil. Unfortunately, the merged airline remains third in the Asian Market and needs to redirect some of its efforts to this region. (US Airways had a practically nonexistent presence in Asia, so American gained very little from the merger in this regard.) [12]

Opportunities

Merger Synergies

The new American conglomerate stands to benefit from many synergies, as US Airways and the old American Airlines are highly complementary companies. With over 900 routes between the airlines, only 12 overlap. Such alignment allows the new American to fill previously existing network gaps and provide travel to more destinations. Specifically, the merged company now provides much greater connectivity on the east coast, as US Airways' routes supplement American's previously weak coverage. This expansion allows the new American to be more self-sufficient and terminate some underperforming partnerships, such as American's previous interline pact with JetBlue.[13]

As previously mentioned, US Airways had an extremely modest international network, which will benefit from joining with American. Parker recently announced that the new American would expand its relationship with Oneworld global alliance, and terminate US Airways' previous membership with Star Alliance. This unification will make Oneworld the leading alliance for capacity flown by U.S. partners, and is an important step towards uniting the Dividend Mile and AAdvantage members under a single rewards program.

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[12] Centre for Aviation, 2012, *American's Revenue Momentum Continues as US Airways Intensifies Merger Push*.

[13] NPR, 2013, *New American Airlines CEO Says Company Will Be Stronger*.

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The expanded networks will also allow American Airlines to offer better scheduling, more opportunities to earn points and more lounge access for frequent flyers. However, the success of these opportunities depends upon the smooth integration of reservation systems and rewards programs.

If executed properly, the merged company should be able capture the cost synergies of reducing redundancies through the design and implementation of a new customer reservation system. This particular aspect of integration however, has presented many challenges for recent mergers. For example, the newly merged United Airlines system actually had to be shut down for a period of time, leaving many passengers frustrated, off-schedule and even stranded. This process will undoubtedly involve expenditures such as hiring implementation consultants, acquiring system hardware and software, and the transformation of many business and financial processes. If American Airlines can learn from the mistakes of recent mergers, a successfully streamlined and improved online customer interface stands to give them a real edge.

Lastly, it is expected that American should be able to reduce debt and interest payments, as well as refinance their airline purchases. Estimates suggest that the company could see cuts as great as $4.3 billion in non-labor costs by 2018.[14]

Ancillary Fees

American Airlines has the opportunity to decouple some services from the historically bundled ticket fares. While fees charged for checking baggage and selective seating are not particularly popular with passengers, airlines argue that the pricing structure of ancillary fees gives customers more control over how much they spend on their travel.

This price discrimination tactic was once reserved for low-cost airlines, whose ancillary revenues can represent up to 38% of revenue. However, it is now a strategy used widely across the industry's legacy carriers as well, and United and Delta represent the success of larger carriers with $5.4 billion, and $2.6 billion in ancillary revenues respectively. [15]

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[14] The Wall Street Journal, 2013, *AMR, US Airways Name Integration Leaders.*
[15] USA Today, 2013, *Airlines Made $27.1 Billion in Ancillary Revenue.*

Pricing Discounts and Promotional Fares

If American Airlines can perfect their use of pricing discounts and promotions, they should be able to greatly increase passenger demand during parts of the year in which they normally experience slack. Such pricing promotions can also be used to highlight services to new cities, capitalize on excess capacity, and manipulate market share.

Not only should the company prepare their own promotional plans, but anticipate when and how other airlines will offer these deals. It is often necessary to match discounts in order to maintain a competitive position within specific markets.

International Expansion

American plans to expand from Dallas and capitalize on the expanding Asian and Latin American markets. Management also intends to build their presence in Asia by adding routes from DFW to Hong Kong and Shanghai in 2014 - a strategic move as United and Delta are fighting for market share that stems from west coast hubs. These new American routes will take advantage of the new flagship long haul 777-300ER aircraft.

Concentrating on strengthening its international position, American should leverage its partnerships with Japan Airlines and Hainan. Cathay Pacific Airlines is also looking to make similar expansion and is wary of American's strengthening ties.[16]

The company already has dominance in Latin American travel, and is positioned post-merger to lure even more business travelers to Latin America through changes at Miami and Houston hubs.

Threats

Monetary Costs of Integration

While mergers certainly provide opportunities for cost-cutting synergies, integration expenses are extremely costly and often underestimated by management teams. To unite American Airlines and US Airways as a single airline, terminals must be integrated, check-in counters co-located, signage changed, planes repainted, and IT systems updated and replaced.

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[16] Centre for Aviation, 2013, *American Airlines in the Hotly Contested US-Asia Market.*

As demonstrated by the recent United Airlines merger, revenue disynergies may also arise during the integration process. Merger-related technology glitches and meltdowns, massive flight delays and strained customer service all have the potential to greatly shrink passenger revenue. American Airlines needs to have plans in place to actively combat these potential issues.

Merger Risks

Perhaps just as important as integrating the technical systems of the two airlines will be reconciling the two vastly different company environments. Merger analysts have not forgotten the threat that is posed by potential cultural clash. Doug Parker and his executive management team are characteristically laid back, casual and biased towards action. The old team of American Airlines, headed by Tom Horton, was much more focused on formalities and nailing down minutia before making decisions. As Parker is taking over the CEO position at the new American, he plans to capitalize on the benefits of both approaches and to nurture a mix of the corporate cultures.[17]

American Airlines has historically hedged their jet fuel costs. The new management however, has not entered into any fuel hedges since the effective date of the merger and maintains that they have instated a policy not to do so. Current hedging contracts will be allowed to expire, but they will not be replaced. Many analysts worry that this will leave the airline unnecessarily exposed to the volatility of fuel prices, but Parker is confident in his decision. A bad US Airways bet in 2008 almost rendered the company bankrupt, and was enough to convince Parker that airlines are protected by a natural hedge (fuel prices versus demand), and ruthless cost discipline.

The merger has also resulted in the elimination of some previously valued partnerships. Leaving some Star Alliance members behind, customers will suffer from a reduction in code sharing and reward overhauls, as well as the shifting of lounge access. Additionally, American Express will no longer be a collaborator.

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[17] Dallas News, 2013, *Goodbye, AMR and US Airways Group, Hello American Airlines Group and its new Management Team.*

Lastly, there exist concerns regarding the merger's possible adverse effects on customer service - an area in which American was already struggling. The recent elimination of 10% discounted bereavement fares does not bode well for the cuts to come; such costs were relatively small to the airline, and provided at least some service credibility. So far, passengers have given American's post-merger comfort and reliability rating an unimpressive 3 out of 5 stars.[18]

Limited Suppliers

The large jet airliner market is essentially characterized as a duopoly, the competitors being Boeing and Airbus. While there are advantages to consistency of infrastructure across the industry, the concentration of suppliers also renders airlines particularly vulnerable to malfunctions in the supply chain, parts and engines, design and mechanical defects, contractual problems, as well as the public perception of manufacturers.

Luckily, the threat of limited suppliers is not unique to American Airlines, and thus they are not in an especially disadvantaged or compromised position within the domestic industry.

Insurance

Since the terrorist attacks of September 11th, 2001 there have been significant decreases in the coverage available within the commercial airline industry, accompanied by an increase in premiums. Such fee hikes have caused airlines, including American, to seek additional subsidized federal insurance programs administered by the FAA. Insurance costs are currently so high that they represent a threat for American Airlines, even if they remain stable - it is more likely however, that costs will fluctuate with economic conditions. Adding to the uncertainty, the claims paying ability of insurers is also vulnerable. Competitive pressures within the industry render airlines limited in their ability to pass on unforeseen insurance hikes to passengers, further exposing their financials.

Route and Cost Competition

The markets in which American Airlines competes are highly competitive. Landing and take-off rights and authorization are only required by a limited number of facilities within the United

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[18] The Economist, 2013, *AMR and US Airways: The Last Great American Airline Merger.*

States, which means that generally, any airline approved by the Department of Transportation (DOT) is authorized to fly scheduled passenger services between any two domestic points. This arrangement leaves American Airlines with competition flying almost all non-stop domestic routes, and even greater competition for destinations requiring connections - major airlines compete via their respective hubs.

As neither American Airlines nor US Airways was run as a low-cost airline pre-merger, the new industry giant will still struggle to compete with low-cost airlines such as Southwest and JetBlue. By cutting frills and services, these smaller airlines are able to offer lower fares to passengers. If low-cost carriers continue to shift demand away from larger more established airlines, legacy carriers like American could be in trouble. The largest threat is posed by the competition of low-cost carriers operating with lower cost structures and in recent years, achieving superior financial performance. Worse still, is that many of them have recently released growth strategies including aircraft purchase contracts.

Strategic Recommendations

Customer Focus

It is essential that the recently merged American Airlines focus extra attention and resources on their customers, now more than ever before. Airline integration has historically spelled bad news for on-time performance, mishandled baggage, and overall customer relations. Since these aspects of service were not strengths of either airline prior to the merger, success will require extra effort on the part of management in order to secure brand equity and customer loyalty. As a legacy carrier that cannot compete with the pricing schedules of low-cost competitors, it must rely on the quality of its services to impress passengers.

In order to achieve the necessary customer service improvement, American Airlines should instate clear and competitive standards. A timeline with progressive goals would help upper level executives convey their expectations to lower level management teams. Further, incentivizing friendly competition between regions with a rewards program may get employees more excited about problem solving and creatively reaching new goals. Management should also consider investing in additional customer service training. No matter how they choose to execute such a change, American Airlines desperately needs to reverse their negative trends in baggage handling, on-time departures and overall customer satisfaction if they wish to maintain a competitive position within the industry.

Throughout the process of uniting the two airlines under a single operating certificate, it will be key for management to be sensitive to integration obstacles that may be faced by employees at all levels within the company. It would be worthwhile for American Airlines to allocate generous time and resources to the careful reorganization of management teams, and facilitation of positive internal relations between workers; inefficient and costly culture clashes will need to be avoided consciously and systematically. Specialized consultants may be useful for assessing cultural diagnostics, the careful planning of respectful and productive communication, as well as the cultivation of mutual respect and commitment to developing their newly combined and high performing culture.

American Airlines will want to take advantage of the opportunity to increase ancillary based revenue, but they must be careful not to scare off passengers. It will be essential for management to strike a balance between the traditional comprehensive service that allows legacy carriers to charge fare premiums, and customizable travel fees that allow for profitable price discrimination.

Lastly, American Airlines must flawlessly integrate their frequent flyer programs if they wish to maintain and build off of existing customer loyalty. For the time being, the two programs are still being operated separately, although customers can earn and redeem miles for both AAdvantage and Dividend Miles on either airline. Until full integration, miles and points cannot be combined to achieve Elite status - an inconsistency that will soon irk flyers. U.S News ranked American's pre-merger AAdvantage program as the 5th best airline rewards program, trailing behind Southwest Rapid Rewards, United Mileage Plus, Delta SkyMiles and JetBlue TrueBlue. Customers will soon demand a superior and streamlined program - American will need to deliver the unparalleled opportunities and rewards they aspire to, or they will risk losing loyal passengers to competitors.

Strengthen Financials

In order to capture the full potential of the merger, American Airlines will need to capitalize on their newly expanded networks. For example, American now has greater East Coast connectivity after merging with US Airways and can collect on revenues that were previously shared with JetBlue through a wasteful interline partnership. Promoting new destinations and routes that fill in previously existing network gaps will increase revenues and customer satisfaction. Additionally, executive management needs to act quickly in order to secure what some analysts are calling American's Achilles' heel: the U.S.-Asia market. While competitors, specifically Delta and United, are busy competing for Asian market share from West Coast hubs like Seattle and San Francisco, American needs to secure dominance from its less than ideal headquarters in Dallas. (American can also capitalize on more geographically convenient transfer points, like its Chicago and Los Angeles hubs, but there they face even stronger competition.) Bolstering this position is important in large part, because Asia is predicted to be a major growth engine of the global economy in the coming decades. Unfortunately, new American routes from DFW to Hong Kong and Shanghai will likely lose money at first, collecting only low unit revenues. However,

the long-term importance of establishing a competitive position outweighs the potential initial losses. Management must move quickly to lock down enough market share to secure at least 3rd place in the Asian market. Luckily, American Airlines boasts dominance in the Latin American market, which is also projected to be an important region of growth. As this strength has the possibility to compensate for weaknesses in Asia, Latin American destinations and routes should be cultivated, not neglected, during the necessary Asian expansion.

American Airlines can also capitalize on their incoming aircraft deliveries. The company should plan to use its new and improved financial position to refinance their jet purchases - securing lower interest and lease terms. Having the youngest fleet in the industry will provide great financial bonuses if properly leveraged. For starters, the company should have standardized procedures in place to help ensure that operational teams appropriately prep new planes in-between flights, maximizing the benefits of superior fuel efficiency. Further, American's new fleet will offer passengers greater comforts and luxury services, creating a product-space advantage over leading legacy carriers that maintain aging aircraft. Newly polished branding and marketing schemes will play a key role in convincing consumers that American Airlines will reign supreme as the new and stable industry leader.