Strategic Report

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Company Essentials

History

Founded by Walter T. Varney and Louis Mueller in 1934, Varney Speed Lines' first flight from Pueblo, Colorado to El Paso, Texas marked the christening of what would become one of the world's largest airlines. Renamed Continental Airlines three years later, the company operated regional flights throughout the American southwest. The opening of its first major route from Los Angeles to Chicago in 1957 is testament to the company's rapid growth after merging with Pioneer Airlines in 1953.

Continental's growing influence was complimented by its innovative "progressive maintenance" program in 1959, which significantly reduced aircraft downtime due to maintenance. At one point the company was able to run its fledging jet fleet 16 hours a day seven days a week.

From 1960 – 1982 Continental underwent significant development. During the Vietnam War in 1963 it moved its headquarters to Los Angeles and ferried U.S. troops between the Mainland and Asia. This marked the beginning of a rapid westward expansion as in 1969 it initiated regular Hawaii – Mainland service routes, and by 1977 it had established routes in Japan, Saipan, Australia, and New Zealand. After merging with Texas International in 1982, Continental was offering service to four continents with a fleet of over 112 aircraft.

However, deregulation in 1978 along with increasing service costs prompted Continental to file for Chapter 11 Bankruptcy protection in 1983. After reorganizing and emerging from Chapter 11 bankruptcy, by 1986 it was the U.S.'s third largest airline after the consolidation of Frontier, People Express, and New York Air. It was during this time that it unleashed its award-winning "OnePass" frequent flyer program. However, by 1990 rising fuel costs due to the First Persian Gulf War forced Continental into its second bankruptcy filing.

In 1993 it was able to emerge from bankruptcy again after Air Partners/ Air Canada invested $450 million in the company. This along with the rapid economic growth in the mid-1990's promoted Continental to expand at an unprecedented scale; it nearly doubled its fleet from 1993-1995. Throughout the mid-1990's Continental won numerous awards for service, and realized record quarter and annual profits.

After relocating its headquarters to Houston, Texas, Continental continued to expand from the mid-1990's until the September 11 attacks, which not only significantly reduced demand for air travel, but combined with increasing fuel costs threatened to unravel the airline's recent progress. Despite the bankruptcies of numerous of its competitors along with rising fuel costs, terrorism concerns, and increased costs due to newly implemented security regulations, Continental has continued onward with what it hopes to be profitable investments. Continental remains heavily invested in the construction and opening of a new 23-gate 600,000 square-foot "Terminal E" at its largest hub, Bush Intercontinental Airport in Houston, Texas.

Furthermore, in 2001 Continental entered into a capacity purchase agreement with ExpressJet, in which it buys all of ExpressJet's seat miles at a negotiated price. This was in response to growing competition from lower cost regional discount airlines such as Southwest and Jet Blue. Continental also wholly owns Continental Micronesia (CMI) which runs service between destinations within the Western Pacific Region and two major Japanese cities.

Market Definition

Continental's primary market consists of the scheduled jet transportation of cargo and passengers between two airports.

NAICS Classification:

Scheduled Air Transportation	#4811
Scheduled Air Passenger Transportation	#481112
Scheduled Air Freight Transportation	#481111

Offering direct service to 228 destinations worldwide (127 domestic and 101 international) Continental is currently the fifth largest hub and spoke air carrier in the United States. Continental's main hubs located at Newark Liberty International, Bush Intercontinental, Hopkins International in Cleveland, are located in areas of high population density covering most regions of the United States. CMI also operates out of its primary hub at Guam International.

While an in depth competitive analysis will be conducted in subsequent sections, Continental's primary hub and spoke competitors include United Airlines, Northwest Airlines, Delta Airlines, and American Airlines – together all of the legacy carriers comprise of the "Big Five." Furthermore,

Continental faces intense competition from smaller discounter operators such as JetBlue Airways, ATA, US Airways and Southwest Airlines.

A Fluid Geographic Definition

Able to magnify its global reach via key Alliance agreements, Continental services destinations throughout Europe, Canada, Mexico, Central and South America, the Caribbean, and several locations in East Asia. Airline alliances typically operate via "code sharing" agreements and reciprocal frequent flyer program participation, and reciprocal airline lounge access. Code sharing allows cooperating parties to place their codes on flights operated by partnered carriers. For example, Continental is permitted to place its code on flights that are actually physically operated by other carriers. Continental has free-sell code shares with all of its partners except for ExpressJet, which allows it to sell seats on the operating carrier's flights from the operating carrier's inventory, but does not expose Continental to any inventory risk of its own. Continental has entered into major alliances with Northwest Airlines and Delta Air Lines, but has numerous code sharing agreements with several other domestic and international carriers. Under its marketing alliance with Delta, Continental plans to join the international SkyTeam Alliance by the second quarter of 2004, which includes Delta, Air France, Alitalia, Aeromexico, Korean Air, and CSA Czech.

Mainline and Regional Service

As with most hub and spoke operators, Continental specializes in long-haul flights between high-volume destinations and is able to expand its reach to less-traveled destinations within the vicinity of major locations by offering regional flights.

Continental coordinates most of its regional service with ExpressJet via an agreement that allows Continental to purchase all of ExpressJet's available seat miles for pre-negotiated prices. Continental is responsible for scheduling and pricing while ExpressJet is accountable for the actual operation of its fleet. Continental is also entitled to all of ExpressJet's revenues, responsible for all revenue-related expenses, and pays ExpressJet based on scheduled block hours.

To better gauge the relative scale of mainline and regional operations, Table 1 illustrates key mainline/regional statistics.[1]

TABLE 1: Mainline/Regional Key Statistics

	2003	2002	2001	2000	1999
Mainline					
Revenue passenger miles (millions)	59165	41016	44238	46896	45540
Passenger Load Factor	75.5	74.1	72.4	74.5	73.2
% of Revenue from Mainline	91%	91%	93%	94%	95%
Regional					
Revenue passenger miles (millions)	5769	3952	3388	2947	2149
Passenger Load Factor	68.5	63.5	62.3	62.2	62.6
Consolidated Load Factor	75%	73%	72%	74%	73%

Source: Continental Airlines Annual Report, 2003

Revenues from regional operations have increased relative to revenues from mainline flights; in 1999 only 5% of Continental's revenues were derived from regional operations, which have steadily increased to comprise 9% of revenues in 2003. This reflects an increasing focus on regional operations as the industry realizes the entry of smaller, efficient, discount airlines such as Southwest Airlines and Jet Blue Airways, as well as increasing overall demand for regional flights due to the lower cost of short-haul flights relative to substitutes such as trains. It is also indicative of capacity increases for ExpressJet and reduced demand for mainline international flights, which will be discussed in the financial overview section of this document.

Competition in the regional market has become intense. From 1999-2003 Continental's regional flights averaged load factors of little over 60%. However, cost-cutting measures, more efficient scheduling procedures, and an increase in user-friendly E-ticketing methods allowed Continental to realize an average regional load factor of 68.5% in 2003.

Labor Relations

While it is still conducting negotiations with its pilots, Continental continues to foster positive relations with its 37,680 full-time employees. Recently in December 2002 Continental ratified a new four-year collective bargaining agreement with its mechanics who are represented by the Teamsters. Continental

[1] Mainline operators primarily include the "Big Five" hub and spoke operators; United, American, Continental, Northwest, and Delta. Regional operators include operators such as JetBlue, Southwest, Midwest, SkyWest and US Airways.

was the only airline to be listed on Fortune's 2003 "Best Companies to Work For," and it has done so for six consecutive years.

Working Capital

As with most airlines the vast majority of Continental's working capital consists of its flight equipment, which accounts for 92% of property and equipment and 62% of total assets.

The Continental fleet includes 355 mainline jets with an average ago of 7.6 years and 224 regional aircraft with an average age of 5.8 years. Continental has the youngest fleet among the other major hub and spoke operators, and continues to focus on the fresh acquisition of equipment. Continental is currently making heavy investments in order to expand ExpressJet's fleet – taking delivery of 36 top-of-the-line ERJ-145XR aircraft in 2003, with 21 additional Embraer jet aircraft due in 2004. It currently has purchasing agreements with Boeing for 63 additional aircraft for its mainline fleet, with 16 due for delivery this year. This reflects the airline's intent to increase capacity in wake of expected increases in demand over the next few years.

Increased Regulations

September 21, 2001 the Federal government passed the Air Transportation System Stabilization Act. This was designed primarily fund measures meant to strengthen airport security. Much of this financial burden is assumed by the government ($5 billion in direct cash payments were paid to airlines to help them cope with the negative shock to demand); however airlines have found their costs attributed to regulation increasing.

As a result of the Aviation Security Act, airlines have been required to absorb increasing fees and taxes directly attributable to increased security requirements. Landing fees increased 9.0%, $52 million, in 2002 as compared to 2001 primarily due to higher landing fees resulting from rate increases and higher facilities rent. Essentially, in order to compensate themselves for lost revenues due to taxes they must pay on decreasing landing weights – due to decreased demand - airports have increased general landing fees.

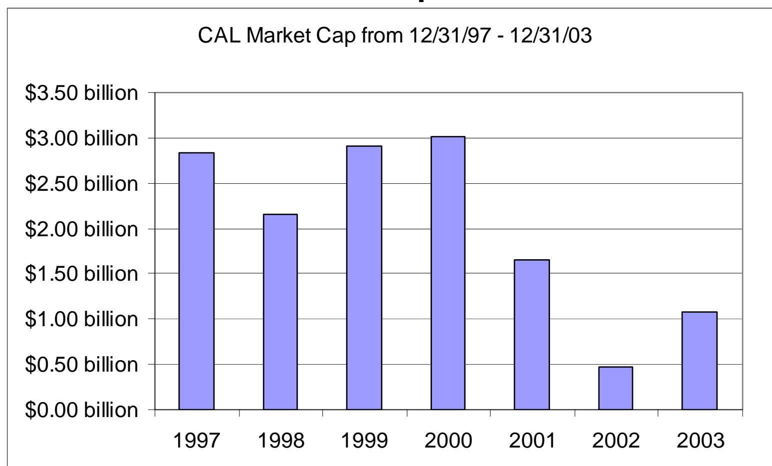
Furthermore, airlines were required to update their flight deck-cabin communications and transponders, and strengthen cockpit doors. The costs of government mandated collision avoidance

systems, airborne wind shear avoidance systems, and noise abatement measures were also shouldered by the airlines. These combined along with increased landing fees are primarily assumed by Continental.

Financial Analysis

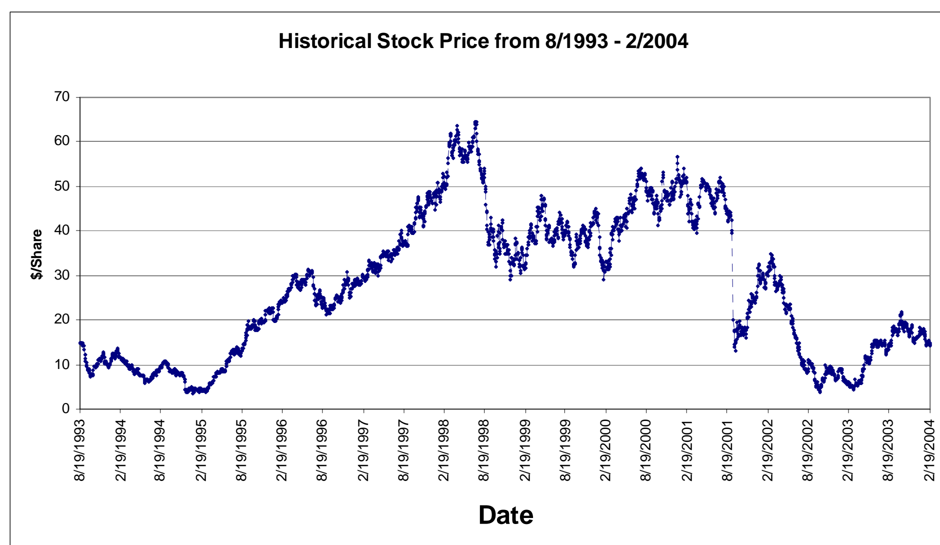
A plethora of events have conspired to reduce demand and increase costs in the airline industry as a whole. The September 11 terrorist attacks combined with the SARS scare and the commencement of war in Iraq reduced demand for air travel significantly. Furthermore, global insecurity, increasing government regulations, increased demand for crude oil, and especially collaborative production methods utilized by OPEC have increased airlines' fuel expenses across the board. In 2002 fuel costs accounted for 11.7% of operating expenses, and by 2003 they had increased to 14.5% of operating expenses. Compared to pre-September 11 figures, Continental reported reduced revenues and higher costs in 2003. This is reflected by the significantly reduced market capitalization in 2003 compared to previous years, most notably 1999 and 2000 (Figure 1). The impact of reduced revenues and increased costs on Continental's stock price is illustrated in Figure 2 as well.

FIGURE 1: CAL Market Capitalization



Source: www.cbs.marketwatch.com

FIGURE 2: CAL Historical Stock Price



Source: cbs.marketwatch.com

Continental's market capitalization reached a peaked in 2000 at $3 billion and bottomed out in 2002 at $480 million. In 2003 the stock price made a modest recovery in the wake of predictions of increased demand for air travel and is currently valued at just over $1 billion; however the stock price remains well below pre-September 11 levels. A summary of key financial statistics follows in Table 2.

TABLE 2: Consolidated Statement of Operations and Key Statistics

($ in millions)	**2003 TTM**	**2002**	**2001**	**2000**	**1999**
Revenue					
Passenger	8,135	7,862	8,457	9,308	8,116
Cargo/Mail/Other	735	540	512	591	523
Total Revenue	**8,870**	**8,402**	**8,969**	**9,899**	**8,639**
Expenses					
Wages/Salaries	3,056	2,959	3,021	2,875	2,510
Aircraft fuel	1,255	1,023	1,229	1,393	756
Cost of Revenue	2,227	2,266	2,627	2,833	2,716
Unusual Income/Expense	77	254	(293)	0	81
Other	988	1,135	1,193	1,135	1,104
Depreciation/Amortization	444	444	467	402	360
Rentals/Landing	620	633	581	532	497
Total Expenses	**8,667**	**8,714**	**8,825**	**9,170**	**8,024**
Net Income	87	-432	-95	343	488
Earnings Per Share	$.58	-$7.09	-$1.71	$5.54	$6.55

Source: cbs.marketwatch.com

Pre-September 11, Continental's net income was reported to be a strong $343 million in 2000 and $488 million in 1999. However, post-September 11 reduction in air travel, increased fuel prices,

increased government regulation, and increased airport taxes combined to force Continental to realize a net loss of $95 million in 2001 and $432 million in 2002. Recent increases in demand, the implementation of cost-cutting measures, and increasingly optimistic expectations in regards to general U.S. economic health allowed Continental to realize a net gain of $87 million in 2003.

From 2002 – 2003 passenger revenue increased 3.5% which reflects an upward trend in demand for regional service. Mainline international flights experienced a reduction in revenues of 0.80% during the relevant period due to SARS concerns. The relative increase/decrease in passenger revenue broken down by region is illustrated in Table 3.

TABLE 3: CAL Increase/decrease in Passenger Revenue by region 2002-2003

Domestic	-0.60%
Latin America	-0.10%
Trans-Atlantic	2.25%
Asia/Pacific	-9.30%
Total Mainline	-0.80%
Regional	34.30%

Source: Continental Airlines Annual Report, 2003

From 2002-2003 passenger revenue from regional flights increased 34.40%, while total mainline passenger revenue fell slightly by 0.80%. The magnitude of the SARS scare is evident; Continental experienced a 9.30% decrease in passenger revenues for flights within the Asia/Pacific region, which primarily includes international flights to destinations that were heavily affected by the outbreak.

Financial Strength

TABLE 4: Key Financial Ratios
As of 2/18/04

Ratio	CAL	Industry
P/E	72.1x	27.8
Debt/Equity	7.6	2.1
Current Ratio	0.9	0.75
EPS 5 year growth	(35.2%)	(1.6%)
Gross Margin	19.3%	25.7%
Return on Assets (5 Yr. Avg.)	1.2%	4.3%
Return on Equity (5 Yr. Avg.)	2.0%	7.8%

Source: Continental Airlines Annual Report, 2003

Analysts are optimistic about Continental's potential growth prospects in the near future given its P/E ratio of 72.1 – the market clearly values Continental stock much more than that of most other airlines. This is in spite of under-average EPS growth over the past five years, which has been -35.2% compared to an industry average of -1.6%. Analysts also expect Continental to be in a prime position to take advantage of increases in international air travel demand, due to the youth of its fleet compared to its hub and spoke competitors; younger fleets are correlated with lower servicing costs and faster turnaround times, which would give Continental a cost-advantage for international service compared to operators with older fleets such as United Airlines, Delta, Northwest, and American Airlines. Continental has the youngest fleet out of the entire airline industry, with an average age of 7.6 and 5.8 years for the mainline and regional fleets, respectively. With a Gross Margin of 19.3%, which is below the industry average of 25.7%, Continental's prospects must be evaluated while taking into account its current position in relation to its competitors. According to Goldman Sachs analysts, as airline demand is expected to pick up in the next fiscal year, Continental stands to gain the most due to its low maintenance costs relative to those required for an older fleet, and because it currently has the capacity to handle the expected increases in demand.

Continental is also leveraged to a higher degree than the industry average, which may be a cause for concern, especially given that EPS growth over the past 5-years (-35.2%) has been slower than that of the industry (-1.6%). Furthermore, its TTM return on assets of.8% is lower than the industry average of 4.5%. Its return on equity over the last 5 years at 2.0% was also lower than the industry average of 7.8%.

Five Forces Analysis

Summary:

Force	Threat
Internal Rivalry	High
Conditions of Entry	Medium
Supplier Power	Medium
Buyer Power	Medium
Substitutes and Compliments	Low-Med

Internal Rivalry

A discussion of internal rivalry within the airline industry can only be discussed within the context of an understanding of industry factors outlined within a Porter's Five Forces Analysis. This document examines industry Conditions of Entry and Exit, Supplier and Buyer Power, and Substitutes and Compliments. Therefore, within this section these factors will be touched upon, and expanded upon in greater detail in subsequent sub-sections.

An overview of the structure of competition within the airline industry must be understood in terms of low-cost discount airlines versus the major hub and spoke "legacy" carriers. The former operate on a point-to-point basis between moderately to heavily traveled routes, and limit their fixed and variable costs by maintaining fleets that are more homogenous than those of the major carriers, which allows them to realize quicker turnaround times at airports and lower maintenance costs. They also pay lower terminal fees, offer less in the way of amenities, offer only one class of service and do not offer advanced seating reservation systems.

With increasing use of the internet as a means to purchase and distribute flight reservations, compared to systems in place prior to the normalization of e-ticketing, modern airlines are now less able to pass along the costs of non-price competition to consumers. Consumers are able to minimize their search costs by using various internet resources that, within a short timeframe, allow them to search for optimal prices, times, and destinations in accordance with their needs. Price competition with other major hub and spoke operators is intense, with low-cost discount operators such as JetBlue and Southwest Airlines at an advantage especially on heavily traveled point-to-point routes.

Table 5 compares Continental's performance with that of its main competitors. Continental is currently ranked as the fifth largest air carrier in the United States.

TABLE 5: Continental Versus Major Competitors

On 2.17.04					
Name	**Market Cap**	**TTM Revenue**	**Net Margin**	**P/E**	**Price**
AMR Corporation	$2,513	$17,440	-7.00%	NM	$15.77
UAL Corporation	$187	$13,725	-20.50%	NM	$1.70
Delta Air Lines	$1,256	$13,303	-5.80%	NM	$10.17
Northwest Airlines	$986	$9,510	2.60%	4.6x	$11.49
Continental Airlines	**$1,005**	**$8,870**	**1.00%**	**72.1x**	**$15.21**
US Airways Group	$239	$6,846	21.30%	0.2x	$4.47
Southwest Airlines	$11,778	$5,937	7.50%	27.7x	$14.92
Alaska Air Group	$736	$2,436	0.40%	85.9x	$27.57
America West	$411	$2,255	2.50%	12.8x	$11.55
ATA Holdings	$116	$1,519	1.30%	19.6x	$9.82
JetBlue Airways	$2,574	$998	10.40%	26.0x	$25.19
SkyWest, Inc.	$1,141	$888	7.50%	17.2x	$19.73
Midway Airlines	$0.46	$312	-7.90%	NM	$0.03

Source: Goldman Sachs Company Reports

While Continental appears to be more effective at cost control in relation to other major hub and spoke operators, the regional carriers' net margins demonstrate the cost advantage that smaller carriers have against their larger competitors. Continental's net margin (net profit/net revenues) was 1%, compared to United Airline's -20.50%, American Airlines' -7%, Delta Airlines' -5.8%, and Northwest Airlines' 2.6%. The regional carriers on average possess higher net margins with Southwest's 7.5%, JetBlue's 10.4%, and Skywest's 7.5%. Table 6 illustrates the advantage that discount operators such as JetBlue Airways and Southwest Airlines have due to lower cost structures. This table compares airlines' expenses per available seat mile (EPASM), which is a standard industry indicator of relative cost effectiveness.

TABLE 6: Expenses per available seat mile for 2003

Airline	Expenses/available seat mile EPASM
JetBlue	6.21¢
Southwest	7.71¢
America West	7.83¢
AirTran	8.26¢
Frontier	8.46¢
American	9.77¢
Continental	9.86¢
United Airlines	9.88¢
Midwest	9.93¢
Alaska	10.19¢
Delta	10.48¢
Northwest	10.71¢
US Airways	12.11¢

Source: Goldman Sachs Company Reports 2/10/04

Southwest and JetBlue with EPASMs of 7.71¢ and 6.21¢ clearly have cost advantages over Continental, which has an EPASM of 9.86¢, while the industry average EPASM is currently 9.82¢,

Not only do Southwest Airlines and JetBlue possess a lower cost structure, but they also fly routes that are either direct or indirect substitutes for Continental's service. For example, Southwest and Continental operate between Dallas – Houston and Austin – Houston from the same airports. Jetblue is able to claim market share from Continental on routes between the same geographical locations by operating out of alternative airports. For example, JetBlue and Continental both service routes from New York to Fort Lauderdale, with Continental operating out of one of its major hubs, Newark, and Jetblue servicing John F. Kennedy International Airport. An analysis competition that Continental faces from these two airlines will be expanded upon within the **problem analysis** section of this document.

Industry Sensitivity to Price Wars

Given the regional carrier's higher net margins on average, it is easy to understand why the major international hub and spoke operators face a high degree of price competition, despite a four-firm

concentration ratio of 74.1. Continental competes directly not only with large carriers such as United Airlines and American Airlines, but it must also contend with smaller more efficient discounters such as Southwest and JetBlue. In fact most actors within the airline industry – one defined by high fixed costs, high entry and exit costs – are keenly aware of price war risk. Operators within the airline industry can adjust prices rapidly weeks or days before a flight depending on expected demand and the current reserved load factor. If a flight remains relatively empty three days before departure for instance, an airline will typically lower a given ticket price, however, operators do ensure that they cover their variable costs by a wide margin given that price elasticity of demand for flights is relatively high. Regional carriers especially advertise discount fares to catalyze traffic during times of weak demand in order to generate cash flow and capture market share. The sensitivity that airlines have in regards to price competition, especially given their sensitivity to fuel price increases and passenger demand, is reflected by United Airlines', US Airways' and several other smaller carriers' filings for bankruptcy since September 11, 2001.

Price wars are typically instigated by companies that are not performing well. As recently as March of 2004, major hub and spoke carriers including Continental were prevented from increasing ticket prices to compensate for rising fuel costs. Northwest Airlines and regional carriers acted as the "spoilers" and prevented the industry from lowering prices – something that most major airlines have been attempting to do for at least three months. While fuel costs have been consistently increasing, Continental's attempts at passing these costs to the consumer are made difficult by the discount airlines' simpler cost structures.

Recent Industry Increases in Revenues and Supply

As of February 2004, all major hub and spoke operators were seeking to increase capacity amid expectations of increasing demand for air travel (Airlines report). Even Continental, which already owns the youngest fleet among all of its major competitors, remains firmly committed to purchase agreements with Boeing. As of the beginning of 2004, Continental had 63 mainline and 50 regional jets on order. While this has generated concerns of excess capacity, major hub and spoke operators such as Continental are expected to gain more than regional ones. This is because major international carriers tend to be much more sensitive to upsurges in business and long-distance leisure travel.

In the wake of concerns over excess capacity, there has also been a recent trend towards increasing demand, which is reflected in an upward trend in revenues within the industry as a whole. Goldman

Sachs reports that in 2003, in the wake of events such as SARS and September 11, demand for air travel had nowhere to go but up, and it eventually did. For example, in the first half of 2003, war and SARS pushed revenues down 35% from 2000 levels within the airline industry as a whole, but by the end of 2003 revenue declines had decreased to less than 20%. Revenues for major hub and spoke operators were up 5% in January compared to the previous year. Unit revenue was up 13% during the fourth quarter of 2003 for transpacific routes, which allowed larger legacy carriers to gain more. Similarly, transatlantic unit revenues were up 11%. Continental stands to gain from this trend given that 40% of its revenue is generated directly from international routes.

However, Continental must remain wary of industry demand's sensitivity to terrorist attacks, and other physical disasters. Decreased demand would lead to excess capacity and may spark a price war among major competitors. While government assistance in 2001 allowed many operators to avoid bankruptcy, such assistance is far from guaranteed. Industry fuel costs are also very sensitive to the degree of collaboration by participants within OPEC, and recent decreases in OPEC quotas combined with the aforementioned factors have pushed prices of oil to 20 year highs. This is expanded upon within the problem analysis section of this document in detail.

Conditions of Entry and Exit

High variable and fixed costs make entry into the industry extremely capital intensive. Entrants into the industry face not only high capital requirements, but must also contend with meeting government regulations, price and non-price competition with existing carriers, and difficulties associated with obtaining market share at major airports. However, while entry is difficult, it is not impossible.

The first step in attaining entry is to secure enough capital for the purchase or lease of a fleet and airport fees. Given that the average cost of a mainline jet is well over $60 million potential entrants must have both solid capital bases and business models before seeking operational approval through the United States Department of Transportation. After approval is secured, the airlines must also deal with obtaining gate access at airports. This may be extremely difficult as existing carriers with significant market share out of a given airport gives those carriers a high degree of control over who may and may not operate out of a particular hub. For instance some major carriers have long-term signatory leases with their major hubs which allow them to stem additional expansion of facilities or even reject the signing of a lease by a new entrant. Continental remains firmly invested in facilities expansion at Bush International in Houston, which has allowed them some degree of influence over who the airport may

lease out gate space to. An existing carrier's established strength of presence at a given airport may pose as a significant difficulty for entrants wishing to capture market share. A table outlining the relative market shares of hub and spoke carriers by airport is illustrated below in table 7.

TABLE 7: Market Share by Airport

Airport	4-F CR	Dominant Carrier (% share)
Chicago O'Hare	87	United Airlines (47)
Dallas Fort Worth International	91	American Airlines (70)
George Bush International	**90**	**Continental Airlines (82)**
Chicago Midway	83	Southwest Airlines (45)
Los Angeles International	53	United Airlines (23)
San Francisco International	68	United Airlines (53)
Miami International	64	American Airlines (48)
JFK International	51	American Airlines (21)
Dulles International	81	United Airlines (43)
LaGuardia	66	Delta Airlines (23)
Detroit International	83	Northwest Airlines (63)

Source: Continental Airlines Investor Relations

Assuming that an entrant secures approval from the U.S. Department of Transportation entrants will also typically face an onslaught of price competition with existing carriers who benefit from economies of scale. Non-price competition is also a threat; airlines have been known to distribute frequent flyer mile bonuses for travelers who choose their service over that of a new entrant. While given the high four-firm concentration ratio of 74.1 major carriers seem to be in stable positions from which they can out-compete and limit the entry of new players, the U.S. government seems committed to giving new entrants a chance via the Department of Transportation's imposition of pricing and capacity rules in 1998 which are designed limit competition between major existing carriers and new entrants.

Entry is not impossible and carriers such as ATA and Southwest have found ways to compete indirectly with larger firms by flying discounted routes between airports with less traffic that charge lower gate fees. For example, instead of flying out of Chicago O'Hare which has a four-firm concentration ratio of 87, Southwest has chosen to fly out of Midway airport, which is slightly less accessible to customers on the south-west side of Chicago, but has lower gate and landing fees. Midway has a fraction of the traffic of O'Hare, but Southwest has managed to make it one of its primary bases.

The cost of exit, while lower than that of entry, is still significant within the airline industry. Existing reservations must be honored or refunds must be provided. Given enough advance notice this is usually

not a problem, however, if a carrier files for bankruptcy protection, carriers do not necessarily have to honor refunds and reservations. Liquidation of assets primarily includes the sale of the fleet.

Supplier Power

Continental Airlines faces pressure from upstream entities for inputs and labor. None of these markets, including the aircraft industry, labor unions, and the oil industry, are characterized by competition. Boeing is the supplier of aircraft to Continental, and, along with Airbus, it is one of two large aircraft manufacturers in the world. Labor unions for pilots, dispatchers, mechanics, and flight attendants have pricing power provided by law, which Continental must abide by. The oil industry, from which Continental purchases fuel, is characterized by a cartel of petroleum-producing nations, notably OPEC.

Despite such pricing power of input industries, Continental Airlines has had relatively few problems in purchasing planes and employing workers. Boeing prices do not offer a significant barrier to Continental, which has been able to purchase three new planes in 2003 and sixteen new planes in 2004, with expected purchases of seven more in 2005. While the lack of substitutes for aircraft gives Boeing pricing power, the fact that Continental relies on Boeing for such a high volume of purchases is certainly beneficial for the airline, which should theoretically be required to pay a lower price for these investments. Such purchases have been made especially easy given recent low interest rates, which can rise and offer significant costs to Continental in better economic times, given the high cost of capital the airline industry.

Unions have posed more significant problems to Continental, but nothing that the company hasn't been able to manage. Much of its labor belongs to unions, and there are currently unresolved labor disputes that the carrier hopes to resolve in 2004. The outcomes, which Continental says are unpredictable, could add significant costs to the carrier's operations. However, recent negotiations between labor groups and US Airways, United Airlines, and American Airlines resulted in concessions that lowered industry standard wages and benefits. Continental's negotiations may be influenced by these beneficial developments.

Despite ongoing negotiations, Continental has been able to effectively deal with its labor to meet its needs while keeping its workers happy. Despite the fact that the airline has eliminated 10,000 jobs since September 11, 2001, with more than 550 employees still on involuntary furlough, it continues to satisfy its workers. It is the only one of the "Big Six" carriers not to have asked for labor concessions since the terrorist attacks, it is striving to bring back as many involuntarily furloughed workers as possible, and

again it has made Fortune's 100 Best Companies for Work For for six straight years. Thus, while Continental's relationship with its unions provides large potential barriers to performance, these barriers have not been sufficient to adversely affect the company at this point in its history.

According to Continental's 2003 Annual Report, Continental's "biggest challenge in the expense area is the cost of jet fuel." Fuel costs represent the strongest upstream power that Continental faces. The principle supplier of oil, OPEC, is an international cartel of oil-exporters and thus has significant pricing power. While the airline industry requires enormous amounts of fuel for its operations, worldwide demand for oil in a multitude of industries is much larger, and so companies like Continental cannot exercise significant buyer power.

At this point in time there are no substitute inputs that can replace fuel, so Continental is forced to accept the prices set by OPEC. The price of fuel is such an important aspect of Continental's operations that it can determine the difference between losses and profits. According to Continental's 2003 Annual Report, "We continue to face oil prices at which our industry has not been historically profitable. Unless oil prices come down, we are unlikely to break even in 2004." A drop in oil prices from $36 per barrel to $25 per barrel, which is still high by historical standards, would increase Continental's annual operating income by more than $400 million in 2004. This is especially frustrating for the airline because the recent rise in prices is expected to offset a substantial portion of cost saving measures.

Therefore, Continental is very susceptible to changes in fuel prices, which are also burdensome because of instability resulting from world events and demand shocks. Unrest in Iraq and other Middle Eastern, oil-producing countries increased the price of fuel by 24.6% between 2002 and 2003. Furthermore, as a result of decreased worldwide jet travel following 9-11, the price of oil per gallon dropped 10.6%. Such instability causes much hardship for Continental Airlines, which has no hedge against fuel prices.

Buyer Power

Prior to the influx of high-speed internet technology the airlines were able to capture a maximum degree of consumer utility through discriminatory pricing. Business travelers for instance would be charged higher fares if they opted out of a Saturday night stay while leisure travelers if identified could be charged lower rates. The rise of internet fare finders such as Orbitz.com, Priceline.com, Travelocity.com, and many others allow users to breeze through multiple fare/schedule combinations with relative ease. Thus, airlines are not able to continue the practice of discriminatory pricing to the degree that they were once able to.

This is not to say that such pricing does not persist in its traditional forms however. In an effort to take advantage of the elasticity of demand that consumers have for air travel, airlines typically offer low fares for advance reservations, increase the price closer to departure to target business travelers, whose inelasticity of demand makes this possible, and lower the prices again just prior to departure to target travelers with very high elasticities of demand, as well as to secure last minute revenue to cover their high fixed costs in light of low variable costs.

Airlines also attempt to reduce buyer power through the use of frequent flier programs and flight clubs. Continental for instance is able to increase switching costs via its award-winning "OnePass" frequent flyer mile program which is held as the gold standard in the industry.

Substitutes and Compliments

Substitutes to Continental's air passenger service are bus, train and automobile travel. These substitutes are imperfect as they are not applicable in all situations. It is quite difficult to travel cross-country in a bus, train or automobile. Although much cheaper than air travel, ground transportation is significantly slower. When traveling for business purposes, this time cost can be prohibitive.

However, in regional transportation, much of this time cost is minimized. When time is not a factor, travel on the West Cost between Los Angeles and San Francisco for example, is much cheaper by ground. Regional transportation for business by ground can sometimes be a more cost efficient substitute. Especially in the Northeast, high-speed trains make ground travel an attractive option.

Business travelers commonly take day-trips between cities on the East Coast. For example, a same-day roundtrip between New York City and Washington, DC can be accomplished by air, bus, train or automobile transportation. Continental's ExpressJet services this route for approximately $290 roundtrip. With a one-hour flight time and one-hour airport wait time, this trip will take approximately 4 hours roundtrip. While air is the fastest mode of transportation, it is also twice as costly as the second most expensive alternative, train travel. A roundtrip train ticket can be purchased from Amtrak for as little as $144. In total, the trip takes 6 hours. While the train takes 50% longer than air travel, its significantly lower price contributes to its viability as a substitute, even for business purposes. The same trip by bus costs $65 and takes 8 hours and can be done by automobile for $40 in 8 hours. There are even less expensive smaller private operators that run direct service between these two cities for $40 for a five hour trip. These substitutes are summarized in Table 8 below.

TABLE 7: Airline Substitutes

Mode of Transportation	Total Roundtrip Cost	Total Time Roundtrip
Air	$290	4 hours
Train	$144	6 hours
Bus	$65	9 hours
Automobile	$40	8 hours

Source: www.orbitz.com, www.priceline.com

For international passenger travel, sea transportation is the only substitute to air transportation. However, virtually no passengers substitute sea transportation for air, unless traveling on a cruise.

In terms of Continental's cargo and mail services, ground transportation is a substitute. Ground shipping is advantageous because it is much cheaper, although at the same time, it is much slower. For high-priority items that need quick delivery over long distances, there are few substitutes for air shipping.

Compliments for Continental's services mainly include tourist goods and services. If hotel prices, attraction/amusement park admission prices, and currency prices are lower, then the demand for air transportation will increase. The availability of free online travel websites also increases the demand for air travel. In general, a healthy economy is a strong determinant of demand for air travel.

With a 5 Porter's Five Forces understanding of the airline industry, PAC Consulting's strategic recommendations to Continental are outlined within the next section.

Evaluation of Key Issues and Recommendations (Problem Analysis)

General Strategic Overview

Amid concerns of industry excess capacity, terrorism-related incidents, and increasing fuel costs, airline stocks in general have decreased since 2000. Furthermore, analysts' projections of company profitability indicate decreased confidence that most carriers will be able to post profits for 2004. While Continental was initially projected to realize a $.42 EPS for the year ending 2004, revised estimates reflect decreased confidence in major hub and spoke operators and Continental no longer expected to be profitable. American Airlines was posted as the only major hub and spoke expected to be profitable. Please refer to Table 8 for a summary of the industry's expected profitability.

Table 8: Projections of Airline Profitability

Company/Index	% Change YTD	# of Up EPS Revisions*	# of Down EPS Revisions*	New 2004 EPS Est.	Old 2004 EPS Est.
American	-1.8	3	4	$0.84	$0.65
Continental	-29.6	0	6	-0.18	0.42
Delta	-34.3	1	6	-4.93	-3.58
Northwest	-30.5	1	2	-2.92	-1.41
JetBlue	-16.8	0	2	0.86	0.97
Southwest	-18.2	0	3	0.54	0.58
America West	-26.0	1	1	1.15	1.02
AirTran	-6.2	0	5	0.64	0.81

* % Change YTD is defined by the cumulative percent change in analysts' EPS estimates since the end of 2003.

Source: Thestreet.com March/April 2004

With no fuel hedges in place, higher than expected fuel prices have decreased Continental's expected profitability estimates. Furthermore, attempts to pass increased fuel costs to consumers failed in March as Continental's attempt to increase ticket prices by more than $10 per roundtrip failed when competitors refused to match. The inability of carriers to increase ticket prices due, and excess capacity have threatened the entire industry according to analysts. Utilizing a standard performance indicator, according to Goldman Sachs analysts, **revenue-per-available-seat-mile** (RASM), RASM is projected to rise only 1.7% in 2004 while capacity will increase 5.2%-7%.

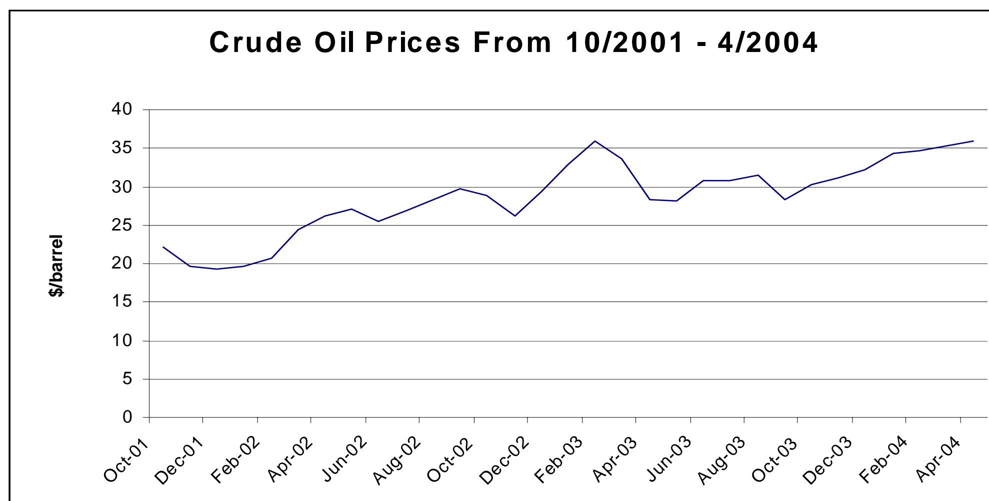
Expected profitability projections fell due to rising fuel prices and the generation of excess capacity in light of slower than expected air travel demand growth. With a glut of flights that can only be sold at heavily discounted rates, industry analysts have lowered their estimates for RASM, which accounts for decreased EPS projections for 2004.

Recommendation 1:

Continental must lower its sensitivity to oil price increases by hedging

As of April, 2004, fuel the price of crude oil was $36/barrel, its highest level in twenty years. Considering that a $1 increase in the price of crude oil translates into a 3 cent per gallon increase in the price of jet fuel, Continental would find it prudent to hedge itself against further increases in the price of fuel. While at the offset of 2004 most hub and spoke operators chose not to hedge themselves against further increases in the price of crude oil – at the time Continental believed that fuel costs would eventually decrease and that the placement of fuel hedges would prevent it from fully benefiting from oil price decreases, the war in Iraq, heightened terrorism-related concerns including the recent Madrid train bombing, and especially OPEC's recent agreement to cut oil production have combined to raise oil prices to higher than forecasted levels. At the outset of 2004 industry analysts believed that oil prices had peaked at $32/barrel, however, prices continued to increase to $36/barrel in April 2004. Figure 3 traces the price of crude oil since October of 2001 – immediately following the terrorist attacks in New York – to the present.

FIGURE 3: Crude Oil Prices



Source: The Financial Forecasts Center.

Southwest Airlines serves as a viable model for the effectiveness of fuel hedges amid heightened risk of demand shocks due to terrorist concerns and the above mentioned factors. Southwest is currently more than 80% hedged this year and previously had spent about $25 million on 2004 fuel hedges. Company executives estimate that the carrier's savings due to these measures have exceeded $240 million.

PAC Consulting strongly recommends that Continental place at least a 25% fuel hedge, meaning that it should cover at least 25% of its 2004 fuel needs with fuel hedges. This figure is based upon past fuel hedges that Continental and major airlines' have held. Furthermore, we recommend that it implements hedges that will cover 40%-50% of its fuel needs for 2005. This may be done through a mixture of options and futures trading.

Recommendation 2:

Continental must suspend additional capital expenditure commitments

Continental's contractual commitments also pose a serious threat to the company's ability to remain financially viable. Earlier in 2004 Continental seemed posed to take advantage of potential surges in air travel demand, especially on its international routes. However, slower than expected demand growth combined with increasing excess capacity may undermine the airline's ability to finance new capital expenditures. According to its 2003 10-K, Continental remained firmly committed to the purchase of 63 new aircraft from Boeing, 16 of which are scheduled for delivery this year. Furthermore, Continental remains highly leveraged; it holds over $6 billion in long term debt and $800 million in equity. $397 million of its debt and $25 million in capital lease obligations will come due this year. It holds an additional $2.4 billion in options to purchase 84 additional Boeing aircraft. According to company estimates, Continental has agreements to finance only 11 of the 16 aircraft that it will acquire this year. Company officials stated in Continental's 10-K that they could provide no guarantees that enough financing will be available for the aircraft scheduled to be delivered this year.

While exact company figures are confidential and thus beyond the reach of this document, we also recommend that Continental examine the feasibility of deferring 2004 capital commitments with Boeing. Such an analysis would compare the costs and benefits of deferral on a per-contract basis. We recommend this because Continental should do all that it can to remain financially solvent.

Continental's ability to seek more financing has been increasingly compromised by its deteriorating credit ratings. Standard and Poor's and Moody's Investors Service both downgraded Continental's credit ratings several times – as of December 31, 2003 Continental's senior unsecured debt rating was Caa2, and CCC+ by Standard and Poor's. These reductions imply increased interest rates and restricted capital commitments associated with issuances of new debt.

Since Continental already has the youngest fleet among major hub and spoke operators, the airline is not at risk PAC Consulting recommends that it suspend entering into any further aircraft purchasing agreements until excess capacity concerns diminish.

Recommendation 3:

Continental must rethink its geographical dispersion

While Continental appears to be more effective at cost control in relation to other major hub and spoke operators, the regional carriers' net margins demonstrate the cost advantage that smaller carriers have against their larger competitors. Figures that were included earlier in the report will be repeated for convenience. Continental's net margin was 1%, compared to United Airline's -20.50%, American Airlines' -7%, Delta Airlines' -5.8%, and Northwest Airlines' 2.6%. The regional carriers on average possess higher net margins (define) with Southwest's 7.5%, JetBlue's 10.4%, and Skywest's 7.5%. Southwest and JetBlue with EPASMs of 7.71¢ and 6.21¢ clearly have cost advantages over Continental, which has an EPASM of 9.86¢. In relation to other major carriers Continental's costs are on par, as the industry average EPASM is currently 9.82¢.[2]

Furthermore, as was mentioned previously in this report, the regional operators Southwest and JetBlue are especially competitive with Continental. Continental faces intense direct and indirect geographical competition with these two airlines. While Southwest actually competes directly with Continental, JetBlue indirectly competes by servicing the same routes as Continental, but via different airports located within the same geographic area.

A breakdown of routes on which Continental faces direct and indirect competition with JetBlue and Southwest is illustrated in Figure 4.

[2] Table 5 within the internal rivalry section of this document illustrates the cost per available seat mile breakdown for major airlines and includes smaller discount operators such as JetBlue and Southwest.

FIGURE 4: Direct and Indirect Competition with Southwest and JetBlue

Direct Overlap between Southwest and Continental:

Between Houston and -
- Las Vegas
- Los Angeles
- Phoenix
- Albuquerque
- El Paso
- Midland/Odessa
- Harlingen/South Padre Island
- Corpus Christi
- San Antonio
- Austin
- Dallas
- Oklahoma City
- Tulsa
- Little Rock
- St. Louis
- Orlando
- Nashville
- Chicago
- New Orleans
- Jackson
- Birmingham

Between Cleveland and -
- Nashville
- St. Louis
- Chicago
- Baltimore/Washington

Tampa to Fort Lauderdale

Jacksonville to Tampa

Indirect Overlap between Southwest and Continental

Between Newark or Long Island/Islip and-
- Baltimore
- Chicago Fort Lauderdale
- Orlando
- Nashville Tampa
- West Palm Beach

*Continental flies out of Newark, and Southwest flies out of Long Island/Islip

Indirect Overlap between Jet Blue and Continental (no direct overlap):

Between Newark or New York City/JFK and -

Newark or NYC/JFK to:
- Buffalo
- Burlington
- Syracuse
- Rochester
- New Orleans
- Tampa
- Fort Meyers FL
- Orlando
- West Palm Beach
- Fort Lauderdale
- Denver
- Salt Lake City
- Sacramento
- San Diego

*Continental flies out of Newark and JetBlue flies out of JFK International.

Source: www.continental.com, www.southwest.com, www.jetblue.com

Both Southwest and JetBlue have strategically located their operations within range of Continental's major operations. With their lower cost structures they are able to claim market share from Continental, especially Southwest, which competes with Continental on at least 28 routes from Bush Intercontinental in Houston, Texas.

While other legacy carriers have attempted to compete with discount airlines by creating specialized "bare-bones" service between routes heavily serviced by smaller operators, PAC Consulting does not believe that this is a viable option. United Airlines and Delta Airlines recently attempted to create low-cost regional service, but have been thus far unable to match the efficiency, turnaround, and profit realized by JetBlue and Southwest. Continental should remain committed to doing what it does best - offering a firm range of international and national destinations in conjunction with its award-winning OnePass frequent flyer mile plan and top-ranked customer service. While a more detailed analysis for this recommendation is implausible because a cost/ revenue breakdown per-route is considered confidential internal information PAC Consulting strongly urges Continental to focus on reducing costs further by eliminated unprofitable routes and redirect resources towards routes where it has a competitive advantage.

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