Strategic Report for JetBlue Airways

Harkness Consulting
Innovation through Collaboration

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Executive Summary

From its initial flight in February 2000, JetBlue emerged into the heavily competitive airline industry as the little airline that could. While legacy carriers declared bankruptcy, JetBlue trounced its competition by offering low-cost, customer-focused service. Under the direction of the energetic David Neeleman, JetBlue became a major player in the airline industry. Operating domestic flights on a point-to-point system, JetBlue primarily manages East-West and Northeast-Southeast routes. While this route structure initially proved profitable for the company, rising costs and heated price competition are currently threatening JetBlue’s market share. The company’s stock price has dropped drastically since reaching a high of over $30 in 2004. Currently priced at less than half its 52-week high, JetBlue must take serious strategic action in order to reinvigorate its business.

After working with low-fare carrier Southwest, a touch-screen airline reservation company, and a small upstart airline in Canada, David Neeleman transformed his brainchild, JetBlue, into reality. Neeleman based his airline around five core values: safety, caring, fun, integrity, and passion. With the pledge to “bring humanity back to air travel,” Neeleman wanted his business to follow altruistic-sounding values in order to make air travel a more pleasant experience for customers and employees. However, at some point in JetBlue’s operating history, the emphasis on customer satisfaction came at the cost of profits.

It is very challenging for a company to remain successful in the airline industry. A company can achieve profits only by maintaining low costs in what has become an extremely price competitive domestic market. High internal rivalry and buyer power combine to drive ticket prices down to marginally profitable levels. At the same time, airlines are subject to ever-increasing fuel and aircraft maintenance costs. Part of JetBlue’s financial struggle in past years results from the company’s lack of a sustainable strategy to manage these expenses. The company originally had lower costs than industry average due to its young aircraft, young

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aircraft crew, and single-type aircraft fleet. However, as their operating aircraft and crewmembers age, JetBlue cannot maintain its previous cost advantage. JetBlue recognizes the need for change. Under new CEO David Barger, the airline has recently entered into a number of new ventures. Since 2007, JetBlue has established an industry-first strategic partnership with Aer Lingus, instituted refundable fares, and sold a 19% stake in JetBlue to Lufthansa. With the Open Air Act bridging the skies between Europe and the US, these ventures offer future avenues for strategic alliances. However, expansion plans will not solve the fundamental operating problems that JetBlue experiences, and this is the area where Harkness Consulting will focus its attention.

In this report, Harkness Consulting focuses on establishing long-term strategies to decrease JetBlue’s cost per available seat mile (CASM) while improving revenue yield. With rising fuel prices and an aging fleet, JetBlue needs to concentrate on decreasing operating expenses wherever possible. While the new management at JetBlue is on the right track by scaling back their expansion plan and charging for additional on-flight amenities, they must take a harder line with these measures. By revitalizing their workforce with a team-based performance pay system and altering their passenger boarding structure, JetBlue can significantly decrease taxi-out time, thus reducing flight delays, decreasing unnecessary fuel expenditures, and increasing potential available seat miles. By following the given strategic recommendations, JetBlue can greatly augment their performance profitability across all areas of their value chain without sacrificing the company’s core strategy of providing a low-cost, high-quality customer experience.

**Company History**

New York-based JetBlue Airways has created a new airline category based on value, service and style. Known for its award-winning service and free TV as much as its low fares, JetBlue offers customers the most legroom in coach (based on average fleet-wide seat pitch for U.S. airlines) as well as complimentary in-flight e-mail and instant messaging services on aircraft, a first among U.S. domestic airlines. JetBlue is also America’s first and only airline to offer its own Customer
Bill of Rights, with specific compensation for customers inconvenienced by service disruptions within JetBlue’s control. JetBlue serves 53 cities with 550 daily flights. With JetBlue, all seats are assigned, all travel is ticketless, all fares are one-way, and an overnight stay is never required.

**Timeline**

In 1999, David Neeleman, who was a co-founder of the low-fare airline “Morris Air”, announced the creation of a new airline. JetBlue (then known as "New Air") placed a $4 billion order with Airbus for up to 75 new A320 aircrafts, and signed leasing agreements for eight more. Later JetBlue announced that it would install an entertainment system on each aircraft that would offer 24 channels of live satellite television at every seat, a first for the airline industry. The year ended on a high note for JetBlue as it received permission for 75 take-off and landing slots at John F. Kennedy International Airport (JFK). In 2000, The United States Department of Transport (DOT) issued JetBlue with a Certificate of Public Convenience and Necessity, representing the “successful completion of the airline’s application processes before both the DOT and the Federal Aviation Administration”. Rapid growth led JetBlue to report $100 million in flown revenue for 2000, and the company continued to offer further destinations.¹

In 2001, JetBlue increased its fleet by another 48 Airbus A320 aircraft valued at $2.5 billion. The company was one of the only airlines to remain profitable in light of the 9/11 terrorist attacks, and in 2001, JetBlue received several airline awards from a number of publishers and reviewers (e.g. number one US domestic airline according to Conde Nast Traveler’s “Reader’s Choice Awards”) for the airline’s excellent service. 2002 continued to be a very strong and profitable year for JetBlue as it ordered ten more Airbus A320 aircraft valued in excess of $500 million. JetBlue flew its five millionth customer and continued expanding the number of offered destinations and flights. On April 11, 2002, JetBlue announced its awaited IPO amidst continuing favorable reviews.
In 2003, JetBlue continued its stellar growth by flying its ten millionth customer and announcing $54.9 million in net income for 2002. Encouraged by US economic prospects, JetBlue ordered 65 more A320’s as well as 100 Embraer 190 aircraft, its first purchase of non-Airbus aircraft. In 2004, JetBlue launched online flight check-in availability and their corporate booking tool, CompanyBlue. After five years of existence, JetBlue had flown 25 million customers.

Further enhancing its online functionality, JetBlue entered 2005 with the Diamond Certificate of Excellence Award, issued by the FAA. The company announced expansion of its maintenance facility at JFK, which added 140,000-square-foot hangar to their property. In 2006, JetBlue added seven new gates to Terminal 6 at JFK, giving the airline 21 gates, at the same time announcing its first ever quarterly loss ($42.4 million). Still, JetBlue faced growing maintenance and fuel costs, resulting in negative profits for these years. In 2007, a new management initiative, “Return to Profitability,” helped JetBlue get into the black. However, the beginning of the year was marred by flight cancellations and delays due to bad weather conditions, leaving passengers on the runways for hours because of poor public communication. This was a major hit to the airline’s credibility. David Neeleman subsequently stepped down from his position as CEO, being replaced by then COO, Dave Barger. In an effort to amend its stained image, JetBlue introduced the JetBlue Customer Bill of Rights – the first in the airline industry. At the end of the year, Lufthansa announced its plan to purchase a 19% stake in JetBlue at $7.27 a share.

In 2008, JetBlue narrowed its capacity growth outlook to between 5 percent and 8 percent from an already lowered range of 6 percent to 9 percent, announcing a sale of six A320’s and deferral on delivery of sixteen A320s from the years 2010-2013. In an effort to keep its market share, JetBlue offered refundable fares, allowing purchasers to change reservations or receive a full refund for cancellations prior to departure. In 2008, JetBlue and Aer Lingus announced an industry-first strategic partnership, allowing customers to book a single fare between Ireland and more than 40 continental US destinations. Still, these recent developments have not remedied the company’s declining stock price, an indication of declining expectations about
JetBlue’s future performance. The company must address potential avenues to lower expenses and raise available seat miles in order to return to its historic level of profitability.

**Competitive Analysis**

**Market Definition**

JetBlue Airways falls under the North American Industrial Classification System as category 48111, “Scheduled Air Freight Transportation.” Within the airline industry, JetBlue operates as a major carrier, the eighth largest in the United States. Major airlines are classified by the ATA as those that generate annual operating revenue in excess of $1 billion. They usually offer nationwide, and in many cases, worldwide service. In 2005, sixteen U.S. passenger airlines were classified by the DOT as major airlines. The majority of major-carriers (excluding Southwest) operate on a hub-and-spoke system, maintaining central hubs in a few cities from where most flights originate, with spokes out to non-hub cities. However, JetBlue distinguishes itself by flying point-to-point routes that minimize connections and travel time. This is evinced by JetBlue’s aircraft utilization, which stands at 12.8 hours per day, one of the highest in the airline industry.

JetBlue’s operating strategy allows the airline to provide low-cost, high-quality customer service between 53 destinations in 21 states, the Caribbean, Mexico, and Puerto Rico. In one day, JetBlue will fly over 500 flights, most of which depart from or arrive into its primary terminals in Boston, MA; Fort Lauderdale, FL; Long Beach, CA; and New York, NY. JetBlue is primarily based out of New York’s John F. Kennedy International Airport with 66% of their total arrivals and departures located in the New York City area.

JetBlue’s position in the industry pits it against several different sub-categories of airlines apart from the major carriers. JetBlue does not have a large international business and primarily competes in the domestic market with 95.2% of its flights operated within the US. They are exposed to competition from smaller, regional airlines which may have better cost structures
and therefore lower prices than the major carriers. However, JetBlue’s point-to-point operating strategy distinguishes the airline from most other discount regional airlines. JetBlue has carved a niche in the airline industry by successfully positioning itself to offer high-quality low-cost service. Due to the company’s low price offerings and point-to-point flight structure, JetBlue competes primarily with Southwest Airlines (LUV). Both companies have comparable growth strategies, focus on improved passenger service, and appeal to the same consumer base. Like Southwest, JetBlue faces the same oligopolistic competition prevalent in the airline industry.

**Internal Rivalry**

There is an inordinate amount of competition in the airline industry. In the deregulated environment, carriers find themselves forced to compete on price alone as the business becomes more and more commoditized. In the absence of product differentiation, consumer loyalty is extremely low, and with the advent of the internet, consumers are able to find the lowest possible airfare from any point on the planet with a single click. This commoditization of the airline industry caused airlines to cut in-flight services and frills in order to keep fares as low as possible. At the same time rising costs, especially in the form of fuel prices, severely hampered all the carriers’ ability to generate an acceptable return on equity over the past several years.

Consumers, especially in the domestic air travel market, have come to expect less from airlines, not more, and are willing to purchase the cheapest fare despite the lack of frills. JetBlue has made its name by offering high quality in-flight services as well as snacks and in-flight entertainment. They invested a large amount of capital into the creation and delivery of in-flight entertainment in the form of LiveTV, and it is questionable as to whether or not this investment has been profitable. JetBlue contends that consumers’ preferences are changing in the form of expecting more services from airlines; however, consumers may only desire these kinds of extra services on longer, international flights, which comprise only 4.8% of JetBlue’s flight operations.

A development that will affect competition in the market is the US-EU Open Skies agreement which stipulates that as of March 30, 2008, EU carriers may fly to any point in the US from the
EU and US carriers may fly from any point in the US to the EU. There is the possibility that new European entrants will carve market share away from the existing airlines, but this is mainly a concern for carriers with large-scale transatlantic operations. JetBlue will not be as affected by this development as some of the other major carriers, but they may lose market share in the form of lost connections from foreign carriers. Talks of a pending commercial agreement with Lufthansa may mitigate any losses that JetBlue would experience.

Entry
There are high barriers to entry in the airline industry. The greatest barrier comes in the form of fixed costs. Purchasing a fleet of aircraft requires high capital expenditures at the inception of the business. Airplane purchases, labor costs, fuel costs, and maintenance produce high variable and fixed costs that make entry into the industry incredibly capital intensive. The price of a commercial airplane, such as the Boeing 737, is approximately $60 million. Should a potential entrant manage to purchase or lease a fleet, they also must maintain cash reserves to handle unexpected maintenance costs, fuel price hikes, and airport fees.

While government regulation has indeed gone down, it is still extremely prevalent in the operations of all US and international carriers. Obtaining terminal space and flight slots at major airports is an extremely difficult proposition, especially at the major airports as congestion in the skies and on the tarmac has increasingly become a problem. The government has recently been taking active steps in several markets to reduce the congestion which may have the added consequence of bestowing some monopoly power on airlines already operating in those markets. JFK recently became an area of concern as the number of flight operations on an hourly basis continually exceeded the maximum operating capacity of the airport. On January 16 of the current year, the FAA in conjunction with the Department of Transportation issued their final slot allocation for JFK. The order will limit flight operations from March 30, 2008 until October 24, 2009. The measure is aimed towards keeping hourly flight operations below the airports capacity of 80 per hour. This should serve to help JetBlue prevent delays both on the
tarmac and in the air, and it will most certainly limit potential future entrants, possibly allowing JetBlue to raise prices on existing flights.4

While not a pressing concern for JetBlue or the other airline industries, a development to take note of is the rise in the number of business jets in use in American airports. Companies and individuals that purchase private airplanes tend to be those that use air travel more frequently, and the loss of such customers, from the airlines’ perspective, is a serious problem. The rise of fractional ownership as offered by companies such as Warren Buffet’s NetJets has only made business travel and leisure travel more affordable for those who would be some of the best customers for the airlines. Furthermore, the advent of very light jets will increase demand for private aviation and consequently decrease demand for commercial aviation. While the airlines might not lose a large number of their customer base, they will lose the most prized customers: those who travel frequently and are more price inelastic. Some examples of very light jets include:

- Eclipse 500: $1.5mm, seats 5
- HondaJet: $3.65mm, seats 6
- Cessna Mustang: $2.6mm, seats 7

These prices are a great deal lower than the $50mm cost of a brand new Gulfstream V.8 While this may not be an issue for the airlines in the next five or even ten years, it will be of major concern over the next several decades and will significantly carve away at their top and bottom lines.

Despite these numerous barriers and developments, the industry is contestable (e.g., imperfectly competitive but subject to potential entry if warranted by prices or profits), as evinced by the growth of low-fare carriers. These market entrants can erode a dominant carrier’s market share, even at large hub airports. Unlike their larger competitors, several of these new market entrants are profitable and continue to experience growth.
As with most cyclical industries where rivalry is intense and profit margins are low and unsustainable, the threat of new entrants is low. Obviously, JetBlue is an exception as a company that began service in February 2000, but it is pursuing a low-fare, point-to-point niche that is far less crowded. Even if a potential entrant can arrange financing, lease a fleet of safe and reliable aircraft, negotiate reasonable gate access and landing fees, and survive high labor and fuel costs, the operating records of the overwhelming majority of airlines indicate that any new entrant will probably lose money in the long term or, at the very least, earn a substandard return on equity capital.

The airline industry further achieves barriers to entry due to cost economies of scale in the market. Airlines may achieve economies of scale by route optimization to increase load factors, efficiently using existing aircraft fleets, decreasing maintenance costs, and leveraging overhead costs for lower operating costs through synergies, as well as by utilizing various forms of code-sharing alliances and cross-ticketing privileges, permitting route expansion and new connecting links. For example, in 2004, Northwest Airlines, Delta, and Continental agreed to permit booking on each other’s flights. While this near-merger strategy is aimed at passenger retention, Sharkey (2003) suggests that it is also likely to reduce flights to smaller or weaker markets. So the question is not whether there are barriers to entry — there are moderate ones — but would a new company want to enter an industry in which the aggregate profits since the Kitty Hawk first took flight in 1903 have been a grand total of $0?

**Substitutes and Complements**

There are very few substitutes for air travel, especially in the US. For some of the shorter routes, consumers may choose driving as an alternative to flying, but for longer routes, this is not feasible. Indeed, Southwest Airlines President Colleen Barrett said, “We have always seen our competition as the car.” In the Northeast, where a large percentage of JetBlue’s flight operations are based, consumers may also choose to take rail travel as an alternative to flying. The average Amtrak trip is approximately 260 miles. Some customers of short-range shuttle flights could substitute to rail travel instead. However, this too becomes infeasible at a certain distance. For
longer distances, there exist no significant substitutes. Businesses, however, do have a substitute in the form of telecommuting and video-conferencing, and this can significantly reduce airline revenues.

There are several complements to air travel and the largest of these are car rental services and hotels. The prices of the goods and services in all three industries tend to move in lockstep, and airline prices tend to lead the other two, not the other way around. Airlines, therefore, are more insulated from price changes in either hotel prices or car rental prices. Furthermore, there is much larger selection in terms of both quality and price in hotels and car rentals than can be seen in the airline industry. Greater selection amongst hotels and car rental services allows consumers to alter their selection in those services to reduce the total cost of travelling while continuing to purchase airline tickets at the same rate. In summary, airlines and hence their pricing tend not to be heavily influenced by complementary industries.

**Supplier Power**

There are several main factor inputs necessary to create an airline: aircraft, labor, and fuel. In the American commercial aircraft fleet there are currently 6,808 passenger aircraft, primarily built by two manufacturers: Boeing and Airbus. The most popular commercial aircraft in the American fleet are the Boeing 737, Boeing 757, and Airbus A320. JetBlue has two models of aircraft that they operate. The first is the Airbus A320. JetBlue originally decided to comprise their fleet of Airbus jets over Boeing because of a favorable leaseback agreement whereby JetBlue was able to defer the payments for a period of time. A second model was introduced in 2003 and is made by the Brazilian firm Embraer. JetBlue originally placed an order for 100 Embraer 190’s in 2003 and has since cut back on the order book in order to manage growth more effectively. The Embraer 190 is a smaller jet that carries 115 passengers. JetBlue currently has 134 aircraft in its fleet of which 104 are the A320’s and the remaining 30 are Embraer 190’s.

JetBlue enjoys the benefits of a non-unionized workforce, and it is imperative that they prevent unionization among their workers in the future. Several airlines found themselves forced into
bankruptcy over the past years due to the adverse effects of union contracts and demands. In an environment of rising operating expenses, mainly due to fuel prices, it is absolutely vital that JetBlue effectively manage all other operating expenses as efficiently as possible.

Managing fuel expenses is the most pressing cost issue for all the airlines. The spike in crude prices over the past five years eroded the operating margins of all carriers and continues to dampen bottom line prospects. The geopolitical environment in the Middle East coupled with the rapidly escalating demand from China and India continues to drive up prices. Refining capacity, while operating slightly below peak levels, will be stretched in the near future to keep up with rising crude input. Simply, the airlines cannot rest their hopes on this being a momentary imbalance in supply and demand, and they must hedge accordingly. JetBlue witnessed at 25% year-over-year increase in fourth quarter fuel expenses with the average unit cost coming out to $2.34 per gallon, ten cents higher than management’s forecasts. Going forward in fiscal year 2008, JetBlue has hedged fuel 39% in the first quarter, expecting prices at $2.50 per gallon in the quarter and $2.55 per gallon on the year. Rising fuel prices should affect all airlines fairly symmetrically. While some carriers still enjoy lower fuel expenses due to previous hedging, they will have to purchase new futures contracts at current levels once the existing contracts expire. JetBlue will need to come up with an effective hedging program and try to cut fuel use wherever possible. The company says they have implemented fuel conservation techniques such as single-engine taxi and rapid deployment of ground power units. Another area in which to improve will be to minimize unnecessary delays, such as gate congestion. Fuel expenses will be a going concern not only for JetBlue but also for the airline industry as a whole.

**Buyer Power**

Air travelers continue to benefit from the intense competition unleashed by the deregulation of domestic airline service in 1978. Since then, adjusted for inflation, domestic airfares have fallen 50.5 percent, helping drive the long-term growth of air travel. Since the dawn of the jet age, real airfares have declined due in part to technological advances and efficiency gains across the
aviation sector. In 1978, the rate of decline accelerated with deregulation. After falling 2.1 percent per year from 1970 to 1978, real domestic airfares dropped 2.5 percent per year from 1978 to 2006. To put this trend into perspective, domestic airfares have grown just 53 percent in unadjusted terms since 1978, while the price of milk has risen 124 percent, new vehicles 340 percent, single-family homes 343 percent, and public college tuition 748 percent.

When the industry was deregulated, passengers, especially for domestic travel, became increasingly sensitive to price. This intense price competition coupled with a large amount of readily available information has given the buyer an incredible amount of power in choosing which airline to fly. This lack of loyalty on the part of the consumer has heightened the competition in the airline industry. JetBlue, like most other airlines, created a loyalty program in the form of TrueBlue in order to retain customers. Loyalty programs have been somewhat effective at mitigating this intense price competition.

Though the industry has engaged, or tried to engage, in what amounts to tacit collusion on prices and flight offerings, an omnipresent threat to the industry is the leisure traveler, who is so price sensitive that brand loyalty engendered by say, frequent flyer programs or other amenities, is generally eclipsed by the prospect of paying comparatively low fares.

**Financial Analysis**

**Operating Statistics**

JetBlue appears, once again, to be on the path to profitability. In 2007, the company reported net income of $18 million and an operating margin of 6.0%, compared to a net loss of $1 million and an operating margin of 5.4% in 2006. In 2007, JetBlue achieved its first year of net profitability in three years.11 In the face of the delays in February and increasing fuel prices, JetBlue regained a strong year-end financial position by expanding its existing route network and establishing cost-cutting initiatives.
Despite a slightly lower load factor (80.7% in 2007 compared to 81.6% the year prior), JetBlue increased passenger revenues by $413 million. This improved revenue stems from higher average fares and a 24% increase in departures. JetBlue opened five new destinations in 2007, closed two of its least profitable routes, and greatly increased the number of flights on existing routes. Older routes consistently outperformed JetBlue’s newer markets, hence the focus on enhancing existing route availability rather than creating new routes. The added flights as well as the purchase/rental of new Airbus A320’s and Embraer 190’s have augmented JetBlue’s available seat miles. Operating capacity increased 12% to 31.9 billion available seat miles in 2007; the increase in capacity was partially offset by the removal of a row of seats on the Airbus A320 and by the shorter average stage length operated by the smaller Embraer 190 planes.

Throughout 2008, JetBlue plans to continue adding new destinations to its flight network. The January 2008 additions of Puerto Plata in the Dominican Republic and St. Maarten in the Netherlands Antilles will be supplemented by flights to Cancun, new service out of LAX, augmented routes to Seattle, and more frequent departures from Long Beach.

JetBlue’s utilization of various distribution channels helped improve revenue earnings in 2007. The company began offering tickets through online travel agencies (e.g. Expedia, Orbitz) and instituted a ten-dollar telephonic reservation fee in an attempt to encourage consumer purchases via the Internet. Still, sales through jetblue.com declined 3.4% in 2007, and JetBlue will continue evaluating options to improve Internet sales.

Providing 97.2% of total operating revenue for the company, passenger sales are the primary revenue stream. However, JetBlue’s other revenue sources contribute to profit growth; ancillary revenues increased by $66 million in 2007 due to excess baggage fees, LiveTV licensing revenues, and higher change fees. Overall, operating revenues appear strong at the end of 2007. EPS dropped from $0.71 in 2003 into negative territory in 2005 and 2006; however, JetBlue closed 2007 with EPS of $0.10, a hopeful indicator of improved future performance.
CASM Analysis

The increase in operating revenues was coupled with an increase in operating expenses. JetBlue maintains one of the lowest costs per available seat mile (CASM) in the industry; however, rising maintenance and fuel expenses threaten this cost advantage. In 2007, JetBlue’s operating expenses increased 20% ($437 million) due primarily to the operation of 21 additional aircraft, which resulted in higher capacity and a 5% increase in average fuel price per gallon. CASM increased 7% to 8.38 cents. While JetBlue’s 2007 CASM remains competitive in the industry, Southwest’s CASM only increased 3.4% to 9.1 cents. If JetBlue cannot adapt to growing salary, fuel, and aircraft maintenance costs, it will be extremely difficult to price competitively against larger discount carriers such as Southwest. JetBlue has historically managed to maintain its low cost structure in the industry; however, the past year’s financial statements present risk factors as JetBlue’s operating expenses continue to build. Specifically, JetBlue needs to keep an eye on maintenance, fuel, and labor costs in the future.

Figure 1: CASM Components for JetBlue 2004-2007:
As shown in Figure 1, the majority of JetBlue’s operating expenses have stayed stable or declined since 2004. JetBlue’s maintenance costs have increased slightly on an absolute basis, but they were the same as percentage of sales. The company’s maintenance materials and repairs are below industry norms due to the young age and standardization of JetBlue’s fleet. At 3.1 average years of age, JetBlue’s fleet is the youngest in the industry. Also contributing to lower maintenance costs, JetBlue only flies two types of aircraft (Airbus 320 and Embraer 190), allowing the company to take advantage of economies of scale in aircraft equipment upkeep. Although JetBlue’s growth strategy provides for the purchase of new aircraft in the future, as current warranties expire, the older planes will incur greater costs. Furthermore, JetBlue has announced plans to enact a year of heavy maintenance on the E190’s before making them a larger percentage of the JetBlue fleet, a risky move considering JetBlue will be the first airline hit by unexpected maintenance/operating costs of this new aircraft as it ages. The expected increase in maintenance costs will pose a threat to JetBlue’s ability to maintain a competitive cost advantage in the industry. While JetBlue’s management should pay attention to potentially rising maintenance costs in the future, they must also continue to keep track of aircraft fuel and labor costs, which have historically accounted for the majority of JetBlue’s operating expenses.

Unlike most airlines, JetBlue has a non-union workforce, which provides the company with greater flexibility and keeps wages down (salaries, wages, and benefits were 24.2% of JetBlue’s total operating expenses compared to 37.4% of Southwest’s). As a percentage of operating expenses, salaries/wages have decreased since 2004 (Figure 1). The good relationship JetBlue
fosters between management and employees allows the company, currently employing 9,909 full-time equivalent employees, to realize lower labor costs in an industry heavily exposed to labor strikes and union demands.

Fuel expenses, on the other hand, have significantly increased CASM. The price and availability of aircraft fuel, JetBlue’s largest operating expense (34.8% in 2007 compared to 20% in 2004) has steadily increased with the price of crude oil since 2004. Aircraft fuel expenses increased 24% from 2006 due to 67 million more gallons of aircraft fuel consumed at a 10 cent increase in price per gallon. While fuel consumption per block hour decreased due to the utilization of the lighter Embraer 190 aircraft, record fuel prices and an increased number of flights led to an overall increase in CASM. Of major concern is the fact that JetBlue’s PRASM (passenger revenue per available seat mile) is lower than CASM, showing that JetBlue is losing money on its core operating business.

JetBlue’s fuel hedging strategy in 2007 (59% of actual consumption hedged) saved the company $35 million in fuel costs. Table 2 represents JetBlue’s fuel hedging plans for 2008; their planned effective hedge is significantly lower than Southwest’s 75% predicted fuel hedge. Thus, while JetBlue has more efficient fuel management policies than most other airlines, it will struggle to price competitively against Southwest if it cannot find other methods to reduce CASM. Cost per available seat mile proves particularly important for JetBlue since it operates within the airline industry niche of low-cost, high-quality service. Self-branded as a low-cost discount carrier, JetBlue must uphold its reputation by keeping CASM at a level comparable to Southwest in hopes of competing effectively against the larger carriers.

**Southwest Comparison**

In completing a CASM analysis of JetBlue, it is instructive to compare JetBlue’s cost structure with rival Southwest Airlines. Figure 2 demonstrates how different components of JetBlue’s total operating expenses in 2007 stacked up against the breakdown of costs for Southwest.
Former CEO of JetBlue, David Neeleman, was able to take much of his experience working with Southwest and apply it to the strategic foundation for JetBlue. Southwest’s success revealed how a focus on customer service, a single-type aircraft fleet, and point-to-point service can earn profits in the airline industry. However, while Neeleman’s strategy differed in a beneficial way due to the increased use of information technology and the employment of a non-unionized workforce, his strategies did not focus on establishing a sustainable strategy for JetBlue’s low-cost growth.

**Figure 2: JetBlue and Southwest CASM Comparison 2007:**

While JetBlue has a clear cost advantage with maintenance fees and employee compensation, this advantage is not sustainable. As stated earlier, JetBlue’s aging fleet will prove more burdensome over the next ten years. As JetBlue’s crew ages, they will receive higher salaries and costly retirement packages. Thus, while these cost advantages have allowed JetBlue to price competitively with Southwest in past years, JetBlue will not maintain these low costs in the future.
Part of Southwest’s success has stemmed from low fuel costs, which as a percentage of operating expenses, are far below those of JetBlue. Southwest’s comprehensive fuel hedging program has contributed to combating rising fuel prices; however, Southwest has sustained low fuel expenses through its route strategy – a feature that distinguishes it from JetBlue. Like JetBlue, Southwest focuses principally on point-to-point service; however, Southwest’s average aircraft trip stage in 2007 was 629 miles, almost half that of JetBlue (1129 miles). Secondly, Southwest’s primary airport is Love Field in Dallas which experiences almost none of the congestion issues that one would see at Kennedy.13 These two operating strategies enable Southwest to achieve high asset utilization because they minimize the amount of time aircraft are on the ground and are able to provide a significantly higher frequency of daily flights. By keeping planes constantly shuttling passengers back and forth, Southwest has dominated the airline industry, bringing in relatively consistent profits for about 35 years. In 2007, Southwest had six times as many departures as JetBlue. Southwest’s route network approach is entirely sustainable, and JetBlue would do well to consider this alternative operating strategy.

**Stock Price Valuation**

Reaching a high of $30 in 2003, JetBlue’s stock price was pushed up due to its great prospects. However, after this peak, JetBlue’s stock has been on a steady decline, dropping drastically after the Valentine’s Day cancellation crisis of 2007. JetBlue’s stock has continued to fall relative to most of its major competitors. Currently priced at about four to five dollars, JetBlue tends to receive an average analyst recommendation of “Moderate Sell.”14
As the peer comparison shows, JetBlue’s stock historically has performed on par with its competitors. However, recently, JetBlue’s stock price has fallen quite a bit below other airlines’ levels and the S&P 500 (\(^{\text{^GSPC}}\) in Figure 3). Compared to regional carriers (such as SKYW), discount carriers (LUV), and legacy carriers (CAL), JetBlue’s stock price has performed poorly.

Given the volatility of the airline industry in lieu of current events and changing regulations, it is difficult to estimate whether JetBlue’s stock is priced accurately. Comparing financial ratios, JetBlue certainly stands out from its peers. Table 3 shows the financial ratios for JetBlue and its top competitors in the sector of regional, low-cost, and major carrier airlines:

**Table 3: Financial Ratios\(^{16}\)**

<table>
<thead>
<tr>
<th>Peer Comparison</th>
<th>Market Cap</th>
<th>P/E</th>
<th>P/Book</th>
<th>EV/EBITDA</th>
<th>EV/Rev</th>
<th>Long Term Debt/Total Cap</th>
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<td>Southwest Airlines</td>
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<td>4.896</td>
<td>0.83</td>
<td>0.23</td>
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<td>1.06</td>
<td>4.522</td>
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<td>Alaska Air Group</td>
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<td>0.79</td>
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<td>AMR</td>
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<td>0.97</td>
<td>4.115</td>
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<td>0.79</td>
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<td>Continental Airlines</td>
<td>2.14B</td>
<td>5.19</td>
<td>1.38</td>
<td>3.913</td>
<td>0.31</td>
<td>0.74</td>
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In this table, companies realizing higher multiples than JetBlue are highlighted in gray. JetBlue has the lowest Price/Book ratio in its peer group; however, comparing Price/Earnings, Enterprise Value/EBITDA and Enterprise Value/Revenue, JetBlue is over-priced compared to its competitors. Comparing current performance ratios to its historical performance multiples, shows that JetBlue is struggling. The airline’s current ROE of 1.81% is half that of its five-year average ROE; net profit margins are only 40% of JetBlue’s five-year average of 1.60.\textsuperscript{17} While JetBlue may have improved its financials in the past year, it still has a long way to go to reach its previous performance levels.

Weakening performance ratios coupled with JetBlue’s high Long-Term Debt/Total Capitalization are potentially worrisome for the company’s expansive growth strategy. While on par with the larger struggling legacy carriers, JetBlue has significantly more long-term debt than other discount or regional carriers. JetBlue reduced this debt in 2007 through the sale of five older Airbus A320’s and through Lufthansa’s $300m investment in the company. Yet, JetBlue still has a number of “other fixed obligations under leases related to aircraft, airport terminal space, other airport facilities and office space.”\textsuperscript{18} The company will continue to accrue debt through commitments to purchase additional aircraft, expand routes, and finish construction on the new terminal in JFK. Since JetBlue has only two lines of credit, the company depends on cash flows from operations to pay back this debt. Should JetBlue fail to generate sufficient cash flows to meet scheduled debt payments (a distinct possibility given the volatile nature of the airline industry), it will need to obtain additional forms of financing, a potential hindrance to JetBlue’s current expansion plan. The company’s high level of fixed obligations puts it at a disadvantage to competitors with better access to capital resources. Given its current growth plan, JetBlue will face trouble finding financing for capital expansion purposes.

Using a DuPont Analysis, we can examine JetBlue’s Returns on Equity relative to its competitors. Not only was JetBlue’s 2007 ROE significantly less than the five-year average, it fell on the low end of its peer group. Table 4 separates ROE for JetBlue and its competitors.
Although JetBlue’s financial leverage ratio is at about median level for its peer group, it is only lower than the leverage ratio of AMR and Continental, which had to amass debt to rebuild operations after their disastrous post-9/11 upheaval. Thus, compared to their primary discount and regional airline competitors, JetBlue has above-average levels of debt. For JetBlue, their extremely low profit margin is pushing down relative ROE. As merger discussions overtake the industry, JetBlue may be forced to consider consolidation to improve its competitive position. Looking at the above statistics, JetBlue’s future looks uncertain. The company does not have the advantage of predictable cash flows and low financial obligations. With the extra cash JetBlue has on hand after the Lufthansa share purchase, JetBlue would do well in considering revenue opportunities outside of the standard airline add-ons, such as vacation getaways and the American Express-branded credit card. For example, JetBlue has recently added a wine sommelier and an “Even More Legroom” program to increase value added on the plane ticket. Charging for existing services and adding extras, the company will raise profit margins while strengthening its competitive advantage. With price competition difficult in the airline industry, JetBlue may have to rely on a certain degree of experimentation and risk-taking with non-price competition to raise its profit margins and improve its financial outlook.

**SWOT Analysis**

**Strengths**

- JetBlue has maintained excellent relations with its nonunion workforce, keeping labor costs low and improving worker efficiency
• Young, standardized aircraft fleet keeps maintenance costs low and streamlines operations (lower training costs for pilots and maintenance technicians, smaller inventory of spare parts, and more fuel efficient aircraft)
• Point-to-point flight structure minimizes connections and travel time
• Strong brand recognition
• Use of technological developments such as automated baggage handling and paperless ticketing decrease distribution and operating expenses
• The FAA’s recent flight slotting in JFK and JetBlue’s opening of Terminal 5 will reduce airport congestion and make JetBlue the largest domestic carrier from JFK

Weaknesses
• Their homebase airport, JFK, experiences the highest congestion in the country, leading to slower flight turnaround and revenue losses
• Low fuel hedging prevents JetBlue from protecting against rising fuel costs
• Highly competitive routes experience heavy price competition
• High debt puts JetBlue at a disadvantage compared to less leveraged competitors given the volatile nature of the airline industry
• Over-emphasis on customer service adds to expenses
• Their frequent-flyer program, TrueBlue, has not been effective at drawing in customers and is weak in comparison with other carriers’ frequent flier programs
• Unprofitable when comparing passenger revenue and cost per available seat mile. Despite high load factor, passenger revenue per available seat mile (PRASM) falls below operating expenses per available seat mile (CASM).

Opportunities
• Partnerships with Aer Lingus and Lufthansa allow for potential synergies such as commercial agreements, code-sharing, and/or supply chain opportunities
• Increased fuel hedging
• Expansion of Caribbean routes using the new Embraer 190 fleet for shorter haul trips originating from Florida
• Closing unprofitable routes that show low potential for future demand
• Charging for in-flight amenities

Threats
• The Open Air Act, enacted in March 2008, allows European airline entrants to further drive internal rivalry in the US airline industry
• Increased service from business and very light jets may take valued customers away from all airlines
• Southwest Airlines’ power to drive ticket prices down
• Rising fuel costs
• Rising maintenance costs as JetBlue’s fleet ages
• Unexpected problems with the new fleet of Embraer 190s
• Economic downturn will lower demand for leisure travel

Strategic Issues and Recommendations
JetBlue enters fiscal 2008 with a worrisome outlook. In its early years, JetBlue performed above and beyond expectations in the airline industry. However, JetBlue’s early advantage was driven almost entirely by its youth – not by a sustainable, profitable strategy. In order to remain a key player in the highly competitive airline industry, JetBlue must focus on increasing PRASM above CASM. By slashing expenses and increasing aircraft utilization time, JetBlue can remain competitive with its ticket prices in order to achieve higher profits and mitigate potential future long-term debt issues.

JetBlue’s foremost goal should be to decrease operating expenses. Since fuel costs represent the largest percentage of operating expenses, all measures should be taken to decrease the amount of fuel used per flight. Other airlines have experimented with various methods to lower fuel requirements. JetBlue should continue seeking to improve its fuel hedging strategy; however,
reducing overall fuel consumption is a more viable measure for the present. By including features such as Blended Winglets on its planes, implementing single-engine taxiing, and cutting off jet engines when planes are on the tarmac, JetBlue can reduce fuel expenditures. Further measures include carrying less water, putting less gas in the tank if unnecessary for that trip, and plugging in planes to ground power as soon as they land.

JetBlue has already started the process of lightening its aircraft. After removing extra trash bins, supplies, seats, and flight kits, JetBlue reduced aircraft weight by an average of 1,079 pounds.\textsuperscript{19} JetBlue should continue with these methods but also consider more extensive changes based around restructuring their takeoff and arrival system.

Quick flight turnaround offers one of the best methods of increasing revenue and decreasing costs. "An airplane that spends an hour on the ground between flights might fly five trips a day...Cut the turnaround time to 40 minutes, and maybe that same plane can complete six or seven flights a day." More flights mean more paying passengers, and ultimately, more revenue.\textsuperscript{20} While several factors (such as baggage handling and aircraft maintenance) contribute to overall turnaround time, passenger boarding plays a highly significant role. With its self-organizing approach to boarding, Southwest has already shown the potential profitability from keeping aircraft constantly shuttling passengers on direct flights. Southwest currently has the second lowest average taxi-out time of the top 20 major carriers, and Southwest’s percentage of on-time arrivals (78.44\% in 2007) is above the average of all major carriers (76.83\%). JetBlue, on the other hand, has the highest average taxi-out time of the top 20 major carriers.\textsuperscript{21} This extra time spent on the ground increases fuel expenses for JetBlue without augmenting passenger revenues. This slow aircraft turnaround is the primary reason behind JetBlue’s low profitability, and Harkness Consulting suggests the following measures to improve operations:

To streamline this segment of their operations, JetBlue’s management should utilize the good relations with employees to institute a performance-based team pay system. JetBlue has an excellent crew and a reputation for unconventional tactics to maximize employee productivity.
Currently, the company has strategies that improve workforce productivity in the marketing and sales phase of the value chain, but JetBlue needs to devote more energy toward increasing worker efficiency in their outbound logistics. In 1995, Continental Airlines introduced an incentive scheme offering monthly bonuses to all hourly employees if they reached a firm-wide performance goal; Continental saw improved on-time performance after the program’s inception. JetBlue should implement a similar incentive-based program in order to increase flight turnaround. By offering bonuses to all employees for improved taxi/takeoff times, JetBlue will encourage innovative development to expedite passenger boarding, cargo loading, and takeoff.

JetBlue should also reconsider its passenger boarding plan. Major airlines have recently used computer simulations to experiment with a variety of boarding procedures that minimize passenger loading time, and JetBlue should similarly engage in this line of research. Figure 4 demonstrates the boarding procedures currently in use (1 represents those who board first, 2 those who board second, etc.):

**Figure 4: Airplane Boarding Systems**

<table>
<thead>
<tr>
<th>Back-front</th>
<th>Rotating-zone (assigned)</th>
<th>Random Block</th>
<th>Reverse-Pyramid</th>
<th>Outside-in</th>
<th>Random (unassigned)</th>
</tr>
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<tr>
<td>1 2 3 4</td>
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JetBlue currently utilizes the random (assigned) seating pattern. Contrastingly, those airlines with lowest taxi-out times (Alaska, Southwest, Frontier) use the back-front or unassigned random system. The back-front system mathematically presents the most efficient method of passenger loading; however, Southwest’s system seems to work best in practice. Southwest’s procedure encourages passengers to show up to the gate on time, and those passengers with the most unwieldy luggage tend to line up first in order to snag overhead bin space and sit down. Both these passenger boarding programs tend to outperform JetBlue’s current boarding design.

Therefore, Harkness Consulting suggests that JetBlue experiment with the back-front and unassigned random seating systems by administering test runs on several routes. Should these alternative boarding processes decrease the average time to takeoff and receive non-negative reactions from the customers, JetBlue should transition into a new passenger boarding system.

After updating their passenger loading and taxi/takeoff strategies, JetBlue should seriously moderate its growth expansion plan. JetBlue is not in a financially strong enough position to continue expansion as planned, and the flexibility of the company’s order book order allows it latitude to analyze existing and potential routes in order to scale back where necessary. For example, many of the flights originating from Orlando to the Northeast are matched by flights departing from Fort Lauderdale. To scale costs back, JetBlue should cancel flights where they do not break even or see high future demand. However, in order to keep available seat miles high, JetBlue should explore the potential advantages by connecting existing terminals (e.g. Chicago to Washington DC). If the airline can discover profitable routes between current operating stations, JetBlue can augment its available seat miles without greatly increasing maintenance or operating expenses.

These strategies will help alleviate JetBlue’s expenses and increase available seat miles, thus raising PRASM relative to CASM. To further increase its profit margins, JetBlue must also reassess its individualized attention to each customer. With airlines, the majority of travelers see ticket price as the bottom line. A friendly pilot and spacious legroom are nice – but on shorter
domestic flights, low rates and reliable service prove more important. Thus, JetBlue must concentrate on keeping ticket prices low to attract customers, while looking for ways to gain additional revenue from their offered benefits. The company has already started along this path by charging for extra luggage, more legroom, etc. However, the airline could also offer food-for-purchase or other amenities. While JetBlue’s primary focus should not be on increasing ancillary revenue, in an industry increasingly subject to heavy internal rivalry, the company cannot afford to give away amenities.

While Harkness Consulting recognizes the strategic possibilities from JetBlue’s recent partnership with Lufthansa, we believe that JetBlue should tread lightly before heavily investing in an operational alliance. Load factor is not an issue for JetBlue. Rather than attempt to bring in higher numbers of passengers, the company needs to resolve the cost issues plaguing its core operating business. At this point, Harkness Consulting believes JetBlue is not in a position to finance additional expansion opportunities with Lufthansa. However, once the airline has gained better control over total operating expenses, JetBlue should pursue additional code-sharing and flight transfer options with Aer Lingus and Lufthansa.

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