Strategic Report for US Airways

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Executive Summary

US Airways Group, Inc. is the fifth largest airline company operating in the U.S. as measured by domestic revenue passenger miles and available seat miles. The company, which was formed in September 2005 through the merger of the former US Airways Group and AmericaWest Holdings, operates a hub-and-spoke network in roughly 230 cities.

Last year was extremely challenging for the airline industry in general and US Airways in particular. As a result of record high fuel prices and falling travel demand, the company realized an annual operating loss of $1.8 billion in 2008. Although 2009 should bring a somewhat more favorable operating environment, US Airways Group must confront a few key challenges to remain competitive in the future.

Currently US Airways, the largest of the wholly owned subsidiaries, has the highest operating cost per available seat mile (CASM) of the major airlines, making it extremely difficult for the it to compete on price with more efficient rivals. With costs reaching 20.8 cents per available seat mile in the third quarter of 2008, US Airways' unit cost was almost twice those of Southwest and JetBlue, two low-cost carriers (LCCs) with whom US Airways competes on the majority of its domestic routes. Although US Airways has taken a number of steps to cut costs and improve liquidity, the company must do more to increase efficiency and improve customer service for its long-term viability.

Oasis Consulting believes that US Airways' operational inefficiency is the key problem requiring action in the short-term. In addition, US Airways has repeatedly been named as having the worst customer service record among major carriers. Streamlining its operations and enhancing service will both improve the experience of passengers and directly feed into cost reduction.

In order to identify key weaknesses in the airline's operations, Oasis Consulting recommends that US Airways perform a comprehensive operations audit. Based on the results, it should develop updated procedures that reflect efficiency-enhancing technology and new ways to streamline their business. Once procedures are in place, management should invest in

training and development for all employees to equip them to carry out company policy efficiently . Oasis Consulting strongly recommends the use of performance-based incentives to improve operations and drive in-flight revenues.

Oasis Consulting also believes that US Airways, which generated 81.9% of its total revenue from the US operations in 2007, is overly dependent on the US market. Expanding its international operations will help the airline enter markets subject to less intense price competition compared to the domestic market.

In the coming months, US Airways should also conduct a thorough analysis of the effect of the la carte fees introduced in late 2008. While the airline's early experience has been positive, Oasis Consulting believes that the program may have costs that in the long-term could mitigate any revenue gains. In particular, a la carte fees could result in efficiency loss, increased liability exposure, and potential reduction in market share if other airlines bundle fees for the various services at a comparable or lower price.

In addition to these changes which can be made in the short-term, US Airways should also join with other legacy carriers to address the structural disadvantage of the hub-and-spoke model relative to that of LCCs. Unlike LCCs, which generally fly point-to-point, hub–and-spoke carriers serve more remote, less profitable routes which might otherwise be left out of national airline networks.

Oasis Consulting recommends that the legacy airlines should lobby the government to find a way to make serving hub-and-spoke routes more profitable. One option would be for the government to designate "underserved" airports and award a passenger grant for each passenger served by an airline from that airport. The government must even the playing field between hub-and-spoke carriers and low-cost carriers in order to preserve our national transportation system in the long-term.

Company Overview

Business Overview

US Airways Group, Inc. is a holding company which provides passenger and cargo air transportation through its wholly owned subsidiaries, US Airways, Inc., Piedmont Airlines, Inc., PSA Airlines, Inc., Material Services Company, Inc. and Airways Assurance Limited, LLC. The company was formed in September 2005 through the merger of the former US Airways Group, which was operating under Chapter 11 bankruptcy protection, with AmericaWest Holdings.

US Airways currently operates in roughly 230 cities, with its largest presence in the United States and Canada and a smaller presence in Latin America and Europe. The company extends its network via the Star Alliance, a marketing and code-sharing partnership which allows airlines to sell tickets on one another's flights and thereby offer customers a broader selection of destinations. US Airways has attempted to integrate the low-fare, low-cost model of Southwest with the international hub-and-spoke model of American Airlines. Operating the fifth largest airline in the United States, as measured by domestic mainline revenue passenger miles ("RPMs") and available seat miles ("ASMs"), the airline maintains primary hubs in Charlotte, Philadelphia and Phoenix and secondary focus cities in New York, Washington, D.C., Boston and Las Vegas.

Company History

The first ancestor of today's US Airways Group was incorporated in Delaware in 1937 as All American Aviation. A glider pilot named Richard C. du Pont founded the company, which used an innovative process involving hooks and ropes to deliver and pick up mailbags in previously isolated communities without having to land. The process was adapted in several different ways by the military for use in rescues and evacuations of soldiers behind enemy lines.

In 1949, the company began adding passenger service to its offering, mainly within the Allegheny region. In 1953, when the company changed its name to Allegheny Airlines, its

passenger service operated as a shuttle between smaller eastern cities and the major destinations served by larger airlines. Allegheny Airlines experienced steady growth through the 1950s and 1960s, upgrading its fleet and relocating its operations and maintenance base from Washington, D.C. to Pittsburgh. In 1968 and 1972, the company expanded by acquiring Lake Central Airlines and Mohawk Airlines. During this growth period, Allegheny was transitioning from its shuttle service into a regional operator by subcontracting routes to smaller independent carriers with lower costs. However, the firm was dogged by a reputation of poor service, earning it the nickname "Agony Air."

The Airline Deregulation Act of 1978, which shifted control over air travel from the political to the market sphere, provided an opportunity for Allegheny to take on longer routes from Texas to the West Coast. The chairman and president, Edwin Colodny, realized that the firm needed to shed its nickname and reputation, so he changed the name to USAir and over time initiated a series of procedural improvements to decrease late flights, deal efficiently with bad weather, and minimize customer complaints.

Industry consolidation in the 1980s led the USAir Group to acquire Pacific Southwest Airlines (PSA) in 1986 for $400 million despite few obvious areas where the firms could be integrated. Nonetheless, PSA increased USAir's traffic by 40% and gave the firm exposure to a variety of West Coast cities.

The late 1980s and early 1990s were difficult for USAir, which was absorbing a difficult merger with Piedmont in 1987. The firm faced large net losses, staff reductions, and wage freezes and lost several domestic routes. One bright note, however, was that it appeared to have shed its reputation for poor service. In 1993, British Airways purchased 25% of USAir, and the two airlines entered into a code-sharing agreement.

By 1994, USAir had seen six straight years of net losses as a result of its high-cost operating structure. A resurgent economy, however, helped bring the company back to profitability in 1995. Stephen Wolf, the former chief executive of United Airlines, joined USAir as chairman and CEO in 1996 following the sudden resignation of CEO Seth Schofield. Wolf

built his strategy around achieving union concessions. USAir, which became US Airways in 1997, finally won a new contract with its pilots.

US Airways launched a single-class subsidiary service known as MetroJet in 1998. The low-fare carrier was meant to head off burgeoning competition from low-cost carriers in the Northeast, particularly Southwest Airlines. Despite returning to profitability in the mid-1990s, US Airways' geographic concentration and high operating costs prompted calls for the company to merge with another airline. In 2000, US Airways announced plans to be acquired for $4.3 billion by UAL Corp., the parent company of United Airlines. However, after strong opposition from unions and antitrust regulators, UAL withdrew its purchase offer.

The September 11 terrorist attacks sent US Airways into financial distress. As the largest carrier at Washington-Reagan, US Airways suffered disproportionately following the airport's extended closure after the attacks. The airline closed its MetroJet network and entered Chapter 11 bankruptcy on August 11, 2002. However, it soon after received a government-guaranteed loan through the Air Transportation Stabilization Board and was able to exit bankruptcy in 2003. Although US Airways made major cost reductions during bankruptcy, it still had higher-than-average per-seat-mile costs. Thus, the carrier was forced once again to seek the protection of bankruptcy courts in 2004. US Airways merged with America West and emerged from Chapter 11 the following year.

US Airways attempted to buy rival Delta, which was reorganizing under bankruptcy protection, in 2006. Ultimately, despite a $10 billion offer from US Airways, the companies failed to make a deal.

In 2007, US Airways posted a net income of $427 million, the fourth most profitable year in the company's history. However, the company was bogged down by customer service woes: a Consumer Reports survey ranked US Airways as the worst airline for customer service. The airline likewise ranked last out of 20 domestic airline carriers for system wide on-time performance in March, April and May 2007, according to US Department of Transportation figures.

In 2008, record fuel prices prompted US Airways to seek new sources of revenue, and the airline began charging passengers for checking luggage and "premium seating" such as window and aisle seats or those near the front of the aircraft. The carrier has likewise announced plans to join other airlines in cutting domestic capacity and reducing its workforce.

US Airways made news in January of 2009 after "multiple bird hits" from a flock of Canada Geese caused both engines of US Airways Flight 1549 to lose power. Pilot Chesley "Sully" Sullenberger successfully ditched the aircraft in the Hudson River. All 155 on board survived what New York's Governor Paterson called "the miracle on the Hudson."

Competitive Analysis

US Airways' business is classified by the North American Industrial Classification System as a Category 4811 "Scheduled Air Transportation" (NAICS). Within this category, the company's primary operations fit into the subcategory of "Scheduled Air Passenger Transportation" (Category 481112). US Airways operates the fifth largest airline in the United States as measured by domestic mainline revenue passenger miles ("RPMs") and available seat miles ("ASMs"). The airline offers scheduled passenger service on more than 3,100 flights daily to 200 communities in the United States, Canada, Europe, the Caribbean and Latin America. US Airways faces competition from other hub-and-spoke "legacy" carriers and newer low-cost carriers, such as Southwest and Jet Blue. Passenger revenues have accounted for more than 90% of operating revenues in the past three years.

US Airways also operates a cargo division categorized as "Scheduled Air Freight Transportation" (Category 481111). Cargo revenues and other sources account for US Airways' remaining operating revenues.

In 2008, the U.S. airline industry faced an extremely challenging environment. Most airlines, including US Airways, incurred significant losses due to staggering increases in the price of fuel throughout most of 2008. Declining profits are nothing new for the industry, however:

2007 is the only year in the past five in which the global commercial aviation industry has realized a profit.[1] According to current estimates, the industry in 2008 lost $8.5 billion, a 1.6 margin loss.

FORCE	STRATEGIC SIGNIFICANCE
Internal Rivalry	High
Supplier Power	High
Buyer Power	Medium/High
Entry and Exit	Medium
Substitutes	Medium
Complements	Low

Internal Rivalry

The airline industry is intensely competitive. US Airways faces competition from both full service hub-and-spoke airlines ("legacy" carriers) and low-cost carriers (LCCs) such as Southwest Airlines and JetBlue Airways. Since the 1978 Airline Deregulation Act shifted control over air travel to the market, the industry has become increasingly fragmented among carriers selling a largely undifferentiated product. Though deregulation has brought billions of dollars in savings to consumers from falling ticket prices, increased competition has put increasing pressure on airlines to cut fares, squeezing profit margins.

A key development that followed deregulation was the development of hub-and-spoke networks, a model used by US Airways and other legacy carriers. Hubs are strategically located airports used as transfer points for passengers and cargo traveling between airports not served by direct flights. The model allows carriers to serve more markets efficiently with a given fleet size than they could if they only offered direct, point-to-point service. Without hub-and-spoke carriers like US Airways, geographically isolated, less profitable routes would not be served. Thus, the hub-and-spoke business model is vital to a comprehensive air transportation system.[2]

The greatest threat to US Airways' domestic operations and those of other legacy carriers has come from low-cost carriers. Their growth has had a profound impact on industry fares and revenues. LCCs reduce their operating costs in a number of ways, such as flying only a single type of airplane, using cheaper, less congested airports, and by flying "point to point."

Flying point to point in particular allows LCCs to pick up only the most profitable routes, which saves an enormous amount of money but limits the breadth of air travel.

Using their advantage of low operating costs, LCCs offer lower fares and shift demand away from traditional network carriers. LCCs now compete for and influence industry pricing on approximately 75% of all U.S. domestic passenger ticket sales compared to less than 20% a decade ago.[3] Moreover, low-fare, low-cost airlines are increasingly offering more passenger amenities than legacy carriers and are receiving a growing number of operating rights in slot-restricted airports. Thus, the threat to network carriers from LCCs will likely remain in coming years.

Other aspects of the competitive landscape of the airline industry are also changing. In the past, passenger loyalty to particular airlines was strong, and frequent flier programs played a major role in locking in customers. Moreover, network carriers were able to segment traffic into higher end "fare buckets," resulting in much of their revenue coming from higher paying passengers.[4] Since 2000, customers have become less loyal and far more price sensitive. The internet has intensified price competition by offering consumers instant information on fares across the industry. US Airways has often elected to match discount or promotional fares initiated by other air carriers in order to compete in those markets. However, the company's ability to compete on the basis of price is limited by its operating costs, highlighting the need to maximize efficiency of operations.

In an attempt to tap an alternate source of revenue and keep base fares low, US Airways and some other carriers have recently begun to offer an a la carte model of service. Although the airline has returned complimentary beverages to all flights as of March 2009, US Airways expects to generate $400 to $500 million in 2009 from a la carte items such as checked baggage fees, Choice Seats, and blankets and pillows.[5] While the new pricing structure does not seem to have dampened demand, according to US Airways CEO Doug Parker, other carriers are likely to follow US Airways' model and lower their base fares accordingly. Moreover, technology will soon enable customers to compare the true cost of their trip, taking into account baggage fees and other surcharges.[6] Thus, the competitive advantage of the program may shrink over time.

Though price is by far the most important factor, US Airways competes to a lesser extent on the basis of scheduling, availability of nonstop flights, on-time performance, amenities provided to passengers, quality of service, on-board products, and markets served. Oasis Consulting believes US Airways should focus on improving its quality of service in order to remain competitive in the future.

Supplier Power

Supplier power in the airline industry is strong. Key inputs for airlines include fuel, aircraft and labor. Airlines typically lease or purchase aircraft from manufacturers by negotiating a separate contract for each order. At the end of 2008, US Airways operated a mainline fleet of 354 aircraft, 63 of which were owned. The remaining 291 were leased. US Airways uses a mix of aircraft manufactured primarily by Boeing and Airbus, companies which enjoy a virtual duopoly in the market for large aircraft. More than 80% of the airplanes used by US airlines are made by Boeing or Airbus.[7] Although the two companies have substantial supplier power over airlines, the presence of at least two competing firms ensures at least some competitive pricing and prevents monopoly power that would result if either manufacturer went out of business. Some airlines have formed alliances with other airlines to purchase aircraft as a bloc, thereby achieving higher bargaining power.

The airlines industry is also labor intensive. In 2008, wages, salaries and benefits represented approximately 18% of US Airways' operating expenses. As of December 31, 2008, the company employed approximately 37,500 active full-time equivalent employees, 87% of whom were represented by various labor unions. Union membership gives employees more supplier power and poses the risk to the company that disgruntled employees could refuse to work and threaten airline operations. This puts US Airways at a disadvantage relative to competitors such as Jet Blue, who enjoy a non-unionized work force.

Aviation fuel has been the largest expense for most airlines in the past few years, and steadily rising prices have squeezed profit margins. The airline industry has little power to affect fuel pricing, which is a function of long-term contracts, spot market prices and point of sale. Because of the amount of fuel consumed by airliners, the industry is extremely sensitive to

changes in the price of fuel. At a consumption rate of approximately 18.7 billion gallons per year, every penny increase in the price of a gallon of jet fuel adds an additional $187 million in annual fuel costs for U.S. airlines.[8]

Some airlines attempt to control fuel costs through hedging, which allows them to lock-in the prevailing price for future deliveries. The hedge helps companies to reduce uncertainty regarding future costs and improve financial planning. Hedging is a gamble, however. During 2008, US Airways recognized a net loss of $356 million related to fuel hedging activities due to the significant decline in the price of oil in the latter part of 2008. Overall, due to the dependence of its operations on fuel, increases in aviation fuel costs pose the greatest immediate threat to the financial condition of US Airways.

Airports, also suppliers for airlines, provide take-off and landing slots, gates, ticketing facilities, and operations areas. As airports become more congested, these necessary inputs will likely increase in price and scarcity.

Buyer Power

Consumers have significant buying power in the airline industry. The number of airlines selling an almost undifferentiated product gives consumers many choices among carriers and makes them highly sensitive to price. The presence of on-line booking sites allows customers to compare and contrast tickets according to price, flight times and number of stops easily to find the best deal. Moreover, low switching costs increase buying power by making it easy for consumers to switch between airlines in response to price changes.

Entry and Exit

The airline industry has high barriers to entry. Most importantly, entry entails significant fixed costs due to necessary capital investments, including the acquisition or lease of a fleet of planes. Variable costs for fuel, labor, and airport fees increase the amount of capital required to enter the market. In 2008, for example, US Airways spent $3.14 billion on its express operations alone.

In addition, the cost advantages brought by economies of scale strengthen barriers to entry. Economies of scale are achieved through route optimization to increase load factors, efficiently using existing aircraft fleets, spreading fixed costs over many ASMs, and by utilizing code-sharing alliances and cross-ticketing privileges which permit route expansion.

Aside from costs, distribution channels in the US make the market less favorable to new entrants, as increasing congestion at major airports has made "slots" (the right to take-off or land at a particular time) at certain airports a valuable commodity. Currently, for example, airlines are unable to add flights at LaGuardia, Kennedy or Newark without acquiring operating rights from another carrier.[9] New airlines may therefore be restricted to offering flights at off-peak times or flying to remote airports.

Perhaps most importantly, the U.S. airline industry has faced an extremely challenging environment that will not likely improve substantially in the short term. Most US airlines incurred significant losses in 2008 owing to staggering increases in the price of fuel and reduced consumer demand. With existing airlines already cutting capacity, the industry seems unattractive for new entrants. Nonetheless, if the long-term trend continues towards increased demand for air travel, the market should become more attractive for new entrants over a longer time horizon.

Exit from the airline industry requires liquidation of capital including fleet, equipment, and rights to terminal space, airport facilities and airspace. Moreover, the Air Safety Transportation Act required all airlines to honor reservations by establishing roll off servicing or a transfer of passengers to other airlines. True exit is therefore a lengthy process. Rather than exit the industry, many airlines including Delta, Northwest, United, Continental, and US Airways have entered bankruptcy protection in order to reorganize and reemerge.

Substitutes

Alternative forms of transport such as cars, buses, and trains are the primary substitutes for air travel. Due to the size of the United States, most long-distance travel is practical only by airplane. The passenger railway infrastructure is relatively limited, and travel by train is time-

consuming and often not significantly cheaper than air travel. The US does have an extensive long-distance bus system which offers service at low fares, but journey times are long when compared with flying. Moreover, most parts of the US are served by airports, so travel time for longer trips is considerably shorter even considering the time taken to reach an airport and check in.

It is important to note that US Airways is more susceptible than most other major airlines to competition from surface transportation. Since the company operates a significant number of flights in the eastern United States, its average stage length is shorter than those of many of its competitors. Customers of US Airways may therefore be more likely to substitute away from air travel given a small change in the relative price.

Telecommunications are also becoming an increasingly important substitute for potential business travelers. As video conferencing technology improves, businesses seeking to reduce costs will likely cut non-essential travel and opt for virtual meetings. Although the market as a whole will continue to grow, telecommunications will likely influence the share of business travelers, who often pay higher fares, in the future.

Complements

The primary complements to air travel are the car rental industry and hotel industry. US Airways has attempted to expand its product offering by bundling travel packages including air transportation, hotel accommodations, car rentals and other travel products. US Airways Vacations ("USV") packages are marketed directly to consumers through retail travel agencies as well as through co-branded websites for ten partner companies, including Costco Travel, Vegas.com, BestFares.com and MandalayBay.com. Since pricing for these products tends to follow airline pricing, their influence on demand for air travel is relatively weak.

Other products and services sold by airports, including food, merchandise, internet, and parking, are likewise complements to air travel. Because airports generally have monopoly power, rates for these products and services tend to be above market.

SWOT

Strengths

- A strong operational network enables US Airways to gain access to key markets as well as enhance the quality of its delivery services.
- Membership in the Star Alliance, which includes 19 member airlines covering 912 destinations across 160 countries, helps US Airways increase its number of flights per day and allows it to offer value-added services to its customers by providing code share service, frequent flyer program benefits, airport lounge access, convenient single-ticket pricing, one-stop check-in, and coordinated baggage handling.
- Improved operational performance helped the company dramatically reduce its mishandled baggage ratio and increase on-time performance, which ranked first among the big six hub-and-spoke carriers in 2008.
- The Company's a la carte revenue initiatives are expected to generate between $400 and $500 million in revenue on an annualized basis.

Weaknesses

- Unprofitable operations during 2008 and early 2009.
- Overdependence on the US market, which accounted for 81.9% of total revenue in 2007.
- Poor customer service record, despite slight improvement in 2008.
- A high CASM limits US Airways' ability to lower prices and maintain profitability on competitive routes.
- Historically weak performance of express passenger and cargo divisions.

Opportunities

- Strong opportunities for international expansion, particularly with growing demand for international travel and primary hubs that are underserved by international traffic.
- Emphasizing reputation for reliability (and living up to that reputation). US Airways was America's number one on-time airline in 2008 among the "Big Six" hub-and-spoke airlines. The company should promote itself as such.

- Growing demand in United States Air Freight sector, with revenues expected to increase by 49.2% during the period 2006-2011, could help the company improve its profitability and market share.
- Reducing domestic ASMs will help maintain prices and ensure fuller flights while demand is down.
- Fleet expansion will allow the company to replace less efficient aircrafts and adjust flight services according to requirements from various segments.
- Adding fee-based internet service and other amenities to certain flights could help attract more business customers and raise additional revenue.

Threats

- Volatility of fuel prices makes cost containment difficult, and continued periods of high fuel costs can have a significant negative impact on operating results.
- The global economic downturn, particularly in the US market, has and will likely continue to affect demand negatively in the airlines industry and prohibit revenue growth in the short term.
- Intense competition in the market could continue to exert pricing pressure on US Airways, forcing it to reduce fares to retain its market share.
- Increasingly stringent environmental regulation could force US Airways to incur significant costs for compliance through obtaining newer lower emission aircraft.
- Customer opposition to a la carte pricing could cause US Airways to lose market share, particularly to low-cost carriers with lower cost structures.

Financial Analysis

Overview

US Airways has been in a precarious financial position since it emerged from bankruptcy in 2005. Although revenues have grown in every year following its bankruptcy, the company realized a profit in only two years (2006 and 2007).

In 2008, US Airways faced an extraordinarily challenging operating environment amid soaring oil prices and a global economic downturn. The company incurred significant losses throughout most of the year as a result of high operating costs and reduced passenger demand. These losses reflect those in the global airlines industry which, according to IATA estimates, lost $8.5 billion in 2008.[10]

Limited data from the first quarter of 2009 suggest an industry that remains weak despite a substantial decline in the price of oil. Although US Airways has yet to release its first quarter results, March traffic data show that the decline in industry-wide load factors is accelerating despite major fare discounts. Analysts expect losses from top carriers, including US Airways, in the first quarter.

2008 Results

In 2008, US Airways realized an operating loss of $1.8 billion and a loss before income taxes of $2.21 billion. The 2008 loss was driven by record high fuel prices, as the average price per gallon of fuel was 44.1% higher in 2008 as compared to 2007. US Airways had been profitable in the two previous years, generating operating incomes of $533 million and $434 million in 2007 and 2006, respectively.

Due to the global financial crisis and losses realized in the past year, US Airways faced substantial liquidity pressures in 2008, resulting in what analysts deem as the weakest balance sheet/liquidity profile of the major legacy carriers. These liquidity pressures were due principally to the company's net loss for 2008 as a result of record high fuel prices. Net cash lost in operating activities was $1.03 billion in 2008 as compared to net cash provided by operating activities of $433 million in 2007, a period over period decrease of $1.46 billion. As oil hit an all time high of $147 per barrel in July 2008, US Airways attempted to contain costs by increasing its fuel hedge position. Its hedge position took the form of no premium collars and swaps, as the cost of traditional call options to lock in fuel cost became too expensive due to the volatility in oil prices. When oil prices dropped unexpectedly in the third quarter of 2008, hedges entered into earlier in the year generated a substantial loss and drain on liquidity for US Airways and other airlines.

As costs soared, total operating revenues in 2008 grew only slightly to $12.12 billion compared to $11.7 billion in 2007. RPMs (revenue passenger miles, which represent one passenger flown one mile) decreased 1.1% as mainline capacity, as measured by ASMs (available seat miles, a basic measure of production) decreased 2.2%. These shifts resulted in a 0.9 point increase in load factor to 81.7%. PRASM (passenger revenue per available seat mile, or total passenger revenues divided by total available seat miles) increased 2.9% to 11.04 cents in 2008, largely due to continued capacity reductions and fare increases throughout 2008.

US Airways, like other major US airlines, cut capacity in response to the weak economic environment in 2008. The airline reduced its fourth quarter 2008 total mainline capacity by 5.9% and its Express capacity by 1.3% on a year-over-year basis. These capacity reductions were intended to minimize the impact of reduced passenger demand by reducing operating costs and keeping fares from falling. US Airways plans to keep capacity down through 2009, and other major US airlines, including low-cost carriers, are taking similar measures. Overall, total domestic ASMs in the US airline industry are expected to be down about 10% in 2009 compared to 2008.[11]

Revenue Analysis

US Airways' mainline passenger and express passenger operations bring in the majority of the airline's revenue, representing 91% of its operating revenue in 2008. While express passenger revenue increased 6.7% from the previous year, revenue from mainline passenger operations increased only .6%. Cargo revenue, which is realized when shipping services for mail and other cargo are provided, brought in an additional $144 million (7.5% of operating revenue) in 2008, an increase of 3.7% from the previous year.

Faced with soaring fuel prices and the economic downturn, US Airways introduced several bold new initiatives in late 2008 to generate additional revenue and keep base fares competitive. These initiatives helped raise "other" operating revenues to $912 million, an increase of $183 million from 2007. For the first time, US Airways also implemented fees for checked baggage (set at $15 for the first bag and $25 for the second), processing fees for travel awards issued through the Dividend Miles frequent traveler program, a new Choice

Seats program, and increases to certain preexisting service fees. Although many airlines followed suit, US Airways initially broke from the pack in deciding to charge for water, sodas and tea. Amid wide spread passenger complaints and negative publicity, however, beverage fees lasted less than six months. Nonetheless, the airline considers the á la carte model a success and remains committed to it for the foreseeable future. US Airways estimates the new fees will bring in $400 million to $500 million in additional revenue for this year.[12]

Cost Analysis

US Airways experienced a dramatic increase in operating expenses through most of 2008, primarily due to soaring oil prices worldwide. Total yearly operating expenses reached $14.02 billion, an increase of $2.73 billion or 24.2% compared to 2007. Mainline CASM (operating cost per available seat mile) increased 29.7% to 14.66 cents in 2008 from 11.3 cents in 2007.

The quarterly average cost per barrel of oil below demonstrates the volatility of fuel prices during 2008:

Table 1: Average Cost Per Barrel of Oil, 2007-2008

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
2008	$98	$124	$118	$59
2007	58	65	75	90
Period over period percentage increase (decrease)	68	91	57	(35)

Source: US Airways 10-K Filing for 2008

US Airways also faced increased expenses per ASM due to rising maintenance expenses and rent and landing fees. Aircraft maintenance expense per ASM increased 25.4% due principally to increases in the number of engine and landing gear overhauls performed in 2008 as compared to 2007. Other rent and landing fees per ASM increased 7.6% due primarily to increases in rental rates at certain airports in the 2008 period.

Comparing US Airways' operating expenses with those of other airlines shows the company trails its competitors in terms of cost containment. US Airways had the highest operating costs of the major network airlines during 2008. Relative to low-cost carriers, the figures are even more striking. At 20.8 cents per ASM during the third quarter of 2008, the company's costs were almost twice those of Southwest and JetBlue. A number of factors contribute to this gap, including less efficient operations, higher wage and maintenance expenses (due to more employees at the top of the pay scale and older aircraft) incurred by US Airways and other legacy carriers, and the company's service to less profitable airports.

Unit costs of network and low-cost carriers are displayed in Table 2 below.

Table 2: Unit Costs of Network and Low-Cost Carriers						
Airlines Ranked by 3rd Quarter 2008 Unit Costs (Cents Per ASM)						
(Operating Expenses per Available Seat Mile in cents)						
3Q 2008 Rank	**Network Airlines**	**3rd Quarter 2007**	**4th Quarter 2007**	**1st Quarter 2008**	**2nd Quarter 2008**	**3rd Quarter 2008**
1	US Airways	15.8	16.4	17	20.1	20.8
2	Northwest	13.6	14.7	16	15.6	18.9
3	United	13.3	14.6	14.9	15.8	17.3
4	Continental	13.5	14	14.9	15.7	16.3
5	Delta	14	15.2	16.5	16.4	16.2
6	American	13.1	13.7	14.4	18	15.9
	Network Carrier Total	13.6	14.5	15.3	16.8	16.6
1	Frontier	10.8	11.5	12	12.5	12.1
2	AirTran	9.5	9.9	10.9	11.4	11.6
3	JetBlue	8.3	8.8	9.5	10.1	10.9
4	Southwest	9.1	9.4	9.7	10.1	10.7
	Low Cost Carrier Total	9.6	9.5	10	N/A	N/A

Source: Bureau of Transportation Statistics

Consultancy Oliver Wyman recently published a study which is useful in comparing the relative efficiency of operations among different carriers. Adjusting for cost data for average stage-length and aircraft type, they recalculated the 2008 Q3 CASM for each carrier assuming that they had purchased fuel at Southwest's fuel prices (which were low due to successful hedging). The results, displayed below[13], imply that US Airways has the least efficient operations of major US carriers. Thus, although some of its cost disadvantages are a consequence of its business model and other factors, the company has a clear opportunity to improve its efficiency. Doing so will be vital to US Airways' long-term viability.

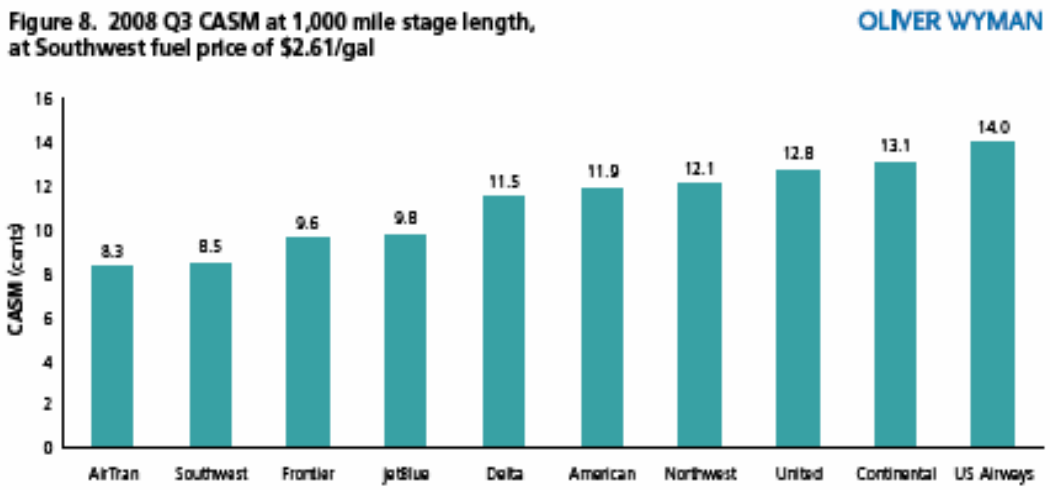


Figure 8. CASM at Southwest Fuel Prices, 1,000-Mile stage length, Airline/Aircraft Combinations.

Source: Hazel, Bob, and Max Kownatzki. Growth Airline Economic Analysis. Rep. Oliver Wyman, 2009.

US Airways has made efforts to cut costs in the past few years to cushion the blow of rising fuel prices to its bottom line. In 2008, changes included the reduction of about 2,200 employees, the closure of US Airways Clubs in the Baltimore / Washington International Airport and the Raleigh-Durham International Airport, and suspension of its Las Vegas night operation. US Airways also intends to save money through returning ten aircraft to leasers by the first half of 2009 and cancelling the leases of two A330-200 wide-body aircraft

that had been scheduled for delivery in 2009. The company will likely cut additional aircraft in the coming year.

Despite its weak financial performance in 2008, US Airways did save money by improving its operations from the previous year. The company increased its on-time performance to 80.1% which was first among the big six hub-and-spoke carriers and second among the ten largest U.S. airlines. US Airways' mishandled baggage ratio per 1,000 passengers likewise improved to 4.77, representing a 40% reduction compared to its 2007 ratio of 8.47. Several initiatives contributed to these improvements, including lengthening the operating day at hubs, increasing the number of designated spare aircraft in order to ensure operational reliability, and implementing new baggage handling software and hand-held baggage scanners. In addition to increasing customer satisfaction, these improvements reflect improved operational efficiency, which directly feed into cost reduction. However, US Airways still trails its competitors in a number of operation and service areas and must continue to make considerable improvements in the future.

Key Financial Performance Indices

US Airways also lags behind its competitors in most key financial performance indices, largely due to its high unit costs. Table 3 on the following page compares the operating margin (a measure of profitability and operational efficiency) of US Airways with that of other network airlines in the past year. Although most of the legacy carriers saw losses, US Airways' numbers are the most grim: The company lost $.20 for every $1 of sales in the third quarter of 2008.

Table 3: Airline Operating Margin Comparison							
3Q 2008 Rank	**Network Airlines**	**Q3 07**	**Q4 07**	**1Q 08**	**Q2 08**	**Q3 08**	**Q3 08 Operating Profit/Loss (Millions)**
1	Delta	8.0%	-0.7%	-3.6%	2.9%	2.2%	$125.0
2	Continental	6.6	2.0	-2.7	-1.9	-4.2	-170.0
3	American	4.5	-2.5	-4.1	-21.8	-4.2	-268.0
4	Northwest	13.2	3.0	-3.8	6.7	-5.7	-222.0
5	United	11.5	-2.4	-9.4	-4.2	-8.4	-469.0
6	US Airways	10.7	-3.6	-6.6	-16.1	-20.5	-688.0
7	Alaska	12.8	-5.4	-8.5	N/A	N/A	N/A
	Seven-Carrier Total	**8.8%**	**-1.1%**	**-5.2%**	**-6.3%**	**-5.8%**	**-$1,692.0**

Source: Bureau of Transportation Statistics

Table 4 on the following page displays other key financial ratios of US Airways and three of its competitors, American, Delta, and Southwest Airlines. Although the company is on par with its competitors in a number of areas, its high debt/equity ratio increases its vulnerability to adverse economic and industry conditions and could limit its ability to obtain additional financing.

Table 4: Key Financial Ratios US Airways and Major Competitors						
Key Numbers	**US Airways**	**AMR Corp.**	**Delta Air Lines**	**Southwest Airlines**	**Industry Median**	**Market Median**
Annual Sales ($ mil.)	12,118.00	23,766.00	22,697.00	11,023.00		
Employees	37,500	84,100	--	35,499		
Market Cap ($ mil.)	408.5	1,316.60	5,088.40	5,327.90		
Profitability						
Net Profit Margin	-18.20%	-8.70%	-39.30%	1.60%	0.60%	-0.40%
Return on Equity	-473.20%	N/A	-162.40%	3.00%	4.90%	3.40%
Return on Assets	-29.00%	-7.70%	-23.00%	1.10%	0.40%	-0.60%
Valuation						
Price/Sales Ratio	0.04	0.06	0.22	0.48	0.19	0.93
Financial						
Current Ratio	0.79	0.63	0.81	1.03	1.03	1.57
Quick Ratio	0.7	0.6	0.8	1	0.9	1.2
Leverage Ratio	0.55	0.46	0.4	0.26	0.42	0.26
Total Debt/Equity	190.21	--	20.39	0.74	1.58	0.73

Source: Hoover's

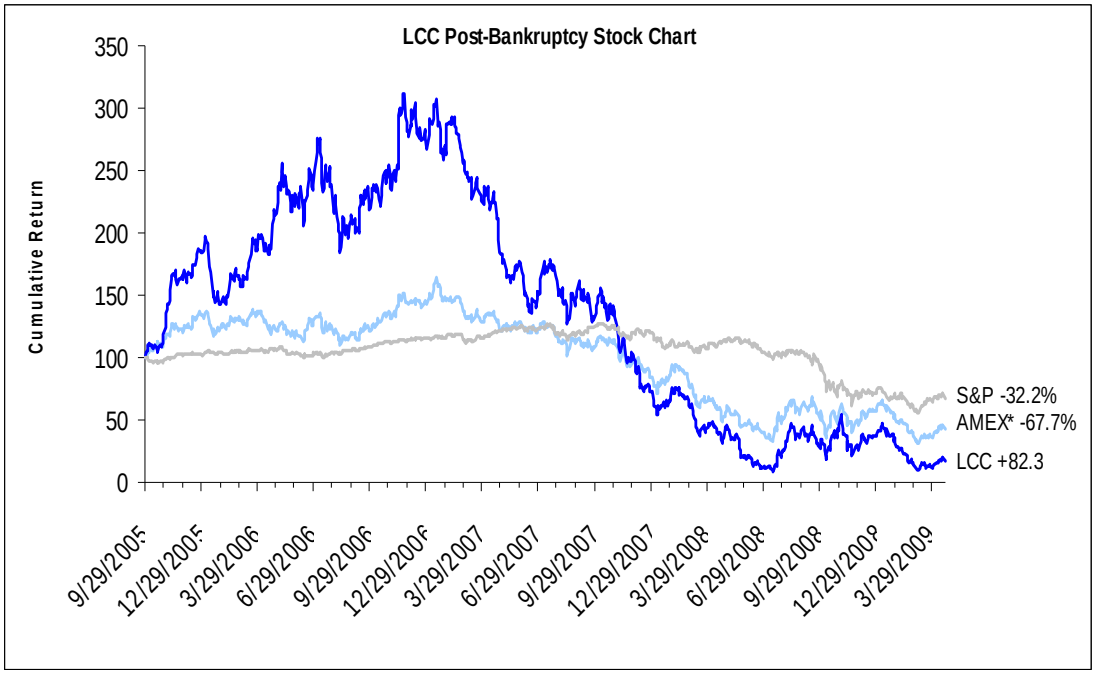
Stock Performance

The following stock performance graph compares US Airways' cumulative total shareholder return on an annual basis of its common stock with the cumulative total return on the Standard and Poor's 500 Stock Index and the AMEX Airline Index (XAL) from September 27, 2005 (the date US Airways stock began trading on the NYSE under the symbol LCC after the completion of the merger) through December 31, 2008. The Amex Airline Index is an equal-dollar weighted index designed to measure the performance of highly capitalized companies in the airline industry. The comparison assumes $100 was invested on September 27, 2005 in US Airways Group's common stock and assumes reinvestment of dividends.

As the chart shows, LCC has taken a steep dive since its peak at the end of 2006.

Table 5: Cumulative Shareholder Return of US Airways and Industry Stocks

	9/27/2005	12/31/2005	12/31/2006	12/31/2007	12/31/2008
US Airways Group, Inc.	$100	$192	$279	$76	$40
Amex Airline Index	100	133	142	84	59
S&P 500	100	103	117	121	74



Source: Yahoo Finance

Outlook

US Airways expects 2009 will bring a more favorable operating environment and a return to profitability for the company. Though most analysts believe industry revenues will fall substantially, US Airways President Scott Kirby has said that the company could turn a profit this year even if passenger revenue falls 15 percent, thanks to substantial capacity cuts and lower fuel prices. The company forecasts its revenues to rise 4% in 2009, despite a 6% decline in capacity in 2009. The company believes that the level of domestic capacity reductions throughout the industry should support continued fare increases in 2009 despite the weakening U.S. economy. US Airways projects a 2009 earnings per share (EPS) of $2.30, versus its 2008 per share loss of $7.72.

Analysts have offered mixed views regarding the future of US Airways stock, though most see at least slight improvement in the short term. Below is a snapshot of what analysts are saying:

> "We think the recent sharp pullback in oil prices is likely to reduce cash usage by LCC over the next 12 months. We view unrestricted cash balances of about $2.3

> billion at the end of the third quarter of 2008 as adequate to fund operations, capital expenditures and debt repayments…. We think the large valuation differential LCC is trading at versus the average of peers makes the shares worth holding."[14]

> "Our 12-month target price of $9 values the stock at an enterprise value to EBITDAR multiple of about 1.9X our 2009 EBITDAR estimate, below the peer average due to our view that LCC lacks the international route network strength of legacy airline peers and has less ability to add additional liquidity if needed than larger peers."[15]

JP Morgan analysts are more optimistic:

> "We remain bullish on airlines in general and can only imagine revisiting our ratings should the paradoxical combination of weakening demand and rising oil occur – or terrorism… We believe LCC remains as highly leveraged as ever to even the slightest fluctuations in demand for air travel. Should the US economy weaken more than currently expected, earnings could be negatively affected accordingly."[16]

Strategic Recommendations

Although 2009 should bring a somewhat more favorable operating environment than 2008, US Airways must confront a few key challenges in order to return to profitability and retain market share. Oasis Consulting believes that US Airways faces fundamental problems at the company and industry level. By tackling the issues described below, US Airways can maximize its chances for long-term success in a competitive industry.

Strategic Recommendation One: Perform a Comprehensive Operations Audit and Invest in Employee Training

Oasis Consulting believes that US Airways' operational inefficiency is the key problem which it must address in the short term. Despite US Airways' improvement in on-time arrivals

during 2008, evidence of persistent weak operations performance is clear: According to the DOT's Air Travel Consumer Report, US Airways' rate of customer complaints has frequently been the highest among major carriers. Most registered complaints have been related to reservations, ticketing, and boarding, or to customer service (defined as rude or unhelpful employees, inadequate meals or cabin service, and treatment of delayed passengers).[17] Other studies confirm this data. The annual American Customer Satisfaction Index by the University of Michigan and J.D. Power and Associates' 2008 North America Airline Satisfaction Study ranked US Airways last and second to last, respectively, in terms of customer service.

These customer complaints generally reflect poor organization by US Airways and poor training of its employees. The experience of airlines shows that there is a strong relationship among strong operations management, quality customer service, low operating costs, and ultimately profitability. US Airways therefore has an opportunity to strengthen its bottom line substantially by improving its operations.

Oasis Consulting recommends that US Airways conduct a comprehensive operations audit to assess its current operations performance. The company should look at all stages of its business, from the time a customer makes reservations to final deplaning and baggage pickup. It should research processes that other airlines have used to become more efficient, such as how Southwest has achieved quick turn-around times through unassigned seating. Investments in technology could likewise streamline operations and improve efficiency. Southwest Airlines is investing $175 million to equip 500 planes with GPS technology that reduces flight times by helping them fly in a straight line. The company says SOUTHWEST? getting each of its planes on the ground just one minute faster, would equate to $25 million in fuel-savings annually. Based on findings from the operations audit, US Airways should put together updated procedures and contingency plans that address new ideas and innovations.

Once procedures are in place, management should invest in training and development for all employees to equip them to carry out company policy efficiently. The present is a particularly opportune time for a new training initiative, as staff cutbacks and recent policy

changes such as baggage fees have redefined the roles of individual employees. More training would promote good relations between management and employees, as it sends the message that the company cares enough about its people to invest in their learning. Happier employees are more likely to treat customers well. Moreover, quality training will help employees run a more efficient operation, as operational problems are frequently caused by poorly trained staff or exacerbated by inappropriate or slow staff response.

Performance-based incentives for employees should also be used to improve operations and drive in-flight revenues. US Airways should set target turnaround times and offer employee bonuses for each month in which they are achieved. Increasing its efficiency of operations could substantially cut costs. Continental Airlines, for example, achieved better on-time performance after introducing monthly bonuses to all hourly employees if they reached a firm-wide performance goal.[18] Another possibility would be to pay crew members and pilots for hours spent in the air, thereby encouraging them to minimize turnaround time and maximize utilization. The airline should also award sales bonuses or commission for a la carte sales on board the aircraft. These policies will help ensure that the incentives of employees are properly targeted toward providing high quality, efficient service.

Strategic Recommendation Two: Expand International operations

Oasis Consulting also advises US Airways to expand its international operations and reduce its dependency on the US market. In 2007, the company generated 81.9% of its total revenue from the US.[19] Expanding international service will be beneficial on several fronts. Overdependence on one region makes the company susceptible to the economic and political situation of the country, as evidenced by the recent decline in demand seen in the recessionary US economy. More importantly, competition on international routes is far less intense than on domestic routes. Domestically, low-cost carriers have continually outperformed US Airways in terms of profitability and continue to capture market share, forcing US Airways to reduce fares to retain its market share and sometimes operate at a loss. Network carriers face little LCC competition on international routes, where profit margins have historically been higher.[20] US Airways should take advantage of its strong

network infrastructure and economies of scale at its hubs to draw in more international traffic.

Strategic Recommendation Three: A La Carte Fees

Oasis Consulting recommends that US Airways conduct a thorough analysis of the effect of the la carte fees introduced in late 2008. While the company's early experience has been positive, US Airways should reassess the costs and benefits of the program later in 2009. In particular, the company should revisit the impact of fees for checked baggage, which certainly encourage customers to bring more luggage into the cabin. Having more carry-on luggage could pose a hazard to passengers and crew members, risking potentially expensive lawsuits against the airline. Moreover, a higher volume of carry-on luggage will likely increase overall boarding times, due to the increase in items that need to fit in overhead bins. If the cabin fills up, crewmembers must go through the trouble of moving overflow below the aircraft. Thus, US Airways should reconsider whether the additional revenue from baggage fees merits the efficiency loss and increased liability exposure.

Strategic Recommendation Four: Lobby for Government Grants for Airports that are Expensive to Serve

Another fundamental problem for US Airways is that the company is competing for many customers with LCCs who can drive down fares as a result of their low operating costs. However, without hub–and-spoke carriers, less profitable routes would not be served. For this reason, both business models are vital to our national transportation system.
Since this is a problem shared among legacy carriers, US Airways should join forces with other legacy airlines and lobby the government to find a way to make serving hub-and-spoke routes more profitable. For example, the government could designate "underserved" airports and award a passenger grant to the airline for each passenger served by the airport. The government has a similar program called the Essential Air Service (EAS) program put in place after the Airline Deregulation Act (1978) to guarantee that small communities that were served by certificated air carriers before deregulation maintain a minimal level of scheduled air service. The Department currently subsidizes commuter airlines to serve approximately 140 rural communities across the country that otherwise would not receive

any scheduled air service. However, rather than contracting with one carrier, a new program should award the subsidy to any carrier willing to serve. Pressing for help for individual airports would avoid the politically controversial issue of choosing which airlines get the subsidy.

These actions could be posed as part of or as a complement to the stimulus package recently put through Congress. The American Recovery and Reinvestment Act of 2009 signed by President Obama on February 17, 2009 includes $1.3 billion for projects and programs administered by FAA. US Airways and other legacy carriers have a strong argument that air service promotes economic activity. By securing grants for less profitable routes, legacy carriers like US Airways would at least face a more level playing field against LCCs, competitors with structurally lower costs.

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