Strategic Report for Southwest Airlines

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April 12, 2006

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Executive Summary

Southwest Airlines has been a strong growth company over the last 35 years. Using its low-cost, passenger friendly, point-to-point operational strategy, Southwest has been able to sustain considerable growth year after year and remain profitable for 33 straight years. Southwest Airlines now has a market capitalization of $14 billion and is positioned as one of the strongest airlines in the struggling airlines industry. Over the last five years as many airlines have reported record losses and five of the ten largest airlines have filed for bankruptcy, Southwest has been able to remain profitable and continue to grow.

While Southwest has gained market share in recent years, legacy carriers have struggled due to depressed market conditions. The enire airline industry has endured expensive labor contracts, soaring energy costs and reduced consumer demand. Southwest has continued to grow in the harsh airline industry because its no frills business model focuses on controling costs. Southwest targets routes with high consumer demand and the advanced experience of Southwest's personnel allow Southwest to quickly turnaround aircraft and keep their planes in the air more hours per day than its rivals. Though the airline industry appears to be on the mends, Southwest has firmly positioned itself as a price leader and a strong market force with the lowest CASM of any airline.

Southwest has experienced remarkable growth in the airline industry by steadily taking market share from large legacy airlines. However, Southwest's success has brought considerable change to the market conditions of the airline industry. The struggling legacy airlines have been forced to streamline operations and new airlines with aggressive low-cost strategies have entered the industry. Damaging price wars have forced many airlines to drastically alter their cost structure in order to remain competitive. By its success, Southwest has begun to alter the market conditions that were partially responsible for its success.

To ensure its future success, Southwest needs to maintain its cost advantages and find new growth opportunities. Even though Southwest has the most fuel hedging of any airline, those hedges only last through 2009. Fuel costs remain a major concern and Pandora Group recommends that Southwest take steps to improve the fuel efficiency of its fleet by purchasing new Boeing 737-700s. Southwest has considerable cash reserves and significantly less debt to total capitalization compared to other airlines which it should use to switch from renting Boeing 737-300s to owning Boeing 737-700s. In addition to fuel costs, labor costs are a primary concern for Southwest. In the next several years many of agreements for Southwest's 80 percent union force will up for negotiation. Southwest's success could lead its union workers to demand more generous compensation packages. Labor market conditions in the airline industry are such that Southwest will need to take a strong position with its unions to maintain/lower costs. Since Southwest has always maintained good relationships with its employees, it may be able to convince its employees to help in maintaining its low cost advantage. Pandora Group recommends that Southwest begin planning its strategy to do just that.

Pandora Group notes that Southwest's traditional strategy for growth may not continue to work in the future. Eschewing the hub airport strategy of the legacy carriers, Southwest traditionally selects only highly profitable city pair routes on which they can establish a strong market share through low prices and high load factors. However, Southwest has already entered many of the most profitable markets. Pandora Group notes that growth opportunities still exist for Southwest in expanding operations in cities already serviced. Pandora Group also recommends that Southwest enter new cities especially those that have been serving as hubs for weakened legacy airlines. Pandora Group also encourages Southwest to expand by opening service to international destinations using their current operational strategy.

Company Background

Southwest Airlines was incorporated as Air Southwest on March 15, 1967 by Rollin King and Herb Kelleher. However, the newly created Texan airline was not to leave the ground for several years. Immediately after inception, Air Southwest was grounded from a joint lawsuit filed by several of the prominent airlines of the time. In 1971, after three years of legal battles, the lawsuit was lifted and the airline that had become Southwest Airlines embarked on its maiden flight.

Southwest Airlines was founded on several principles of business; “If you get your passengers to their destinations when they want to get there, on time, at the lowest possible fares, and make darn sure they have a good time doing it, people will fly your airline”.[1] Southwest realized the potential of airline travel to be used by the common people and not as just a means of travel for the elite. From the beginning, Southwest’s operational strategy profited from its understanding that in the airline industry customers’ choices were primarily driven by price. The beginning of Southwest Airlines in 1971 can be seen as the start in the series of events that led to the deregulation of the airline industry in 1978. Southwest’s competitive business model directly challenged the government protected industry that had always been dominated by a few large incumbent airlines.

Southwest eventually was to revolutionize the airline industry but it started from an extremely humble beginning. The airline only had three Boeing 737-200 aircrafts in 1971 when it commenced its service out of Love Field in Dallas. Southwest began with short, no-frills flights between Dallas, Houston and San Antonio.[1] The short hop service and simple fare structure became the standard for Southwest. Southwest’s intentions were not to compete with the incumbent long freight airlines but instead to provide an alternative option to ground transportation between cities. That is why Southwest has remained in regional airports that they believed are closer to their passengers instead of nearby international airports. Maintaining that philosophy, Southwest has stationed its headquarters and operations out of Love Field in Dallas instead of Dallas/Forth Worth International Airport.

By 1977, Southwest was flying into Austin, Corpus Christi, El Paso, Lubbock, Midland/Odessa and Rio Grande Valley.[1] With the official deregulation of the airline industry in 1978, Southwest began to plan the expansion of its operations outside of Texas. However, with the urging of several competing airlines, Congress passed the Wright Amendment. The Wright Amendment restricted Southwest's flight capabilities from Love Field to only Texas and the states directly surrounding it.[2] Southwest's growth plans were stifled but were not stopped. In 1979, Southwest added it first intra-state flights by providing service to New Orleans from Dallas.[1]

As Southwest grew throughout the early 1980s it continued to add cities to its destination list. In 1982, Southwest added San Francisco, Los Angeles, San Diego, Las Vegas, and Phoenix to its list of cities. Then again in 1985, Southwest added St. Louis and Chicago. With rising gas prices during the 1980s, customers realized that Southwest represented a viable alternative to ground transportation between several major cities.

The 1990s Southwest become a prominent airline in the US. In 1992, Southwest won its first Triple Crown award which it went on to win for three consecutive years. The Triple Crown is a prestigious award given to an airline that has the best on-time record, best baggage handling, and fewest customer complaints during that year as published in U.S. Department of Transportation consumer reports. Additionally, each year

Southwest added more destination cities until it included Seattle, Spokane, Portland, Boise, Tampa Bay, Omaha, Manchester, Orlando, and New York to name just a few. Each city was selected because it represented an area in the US with high passenger frequency and demand with considerable opportunity for productivity for Southwest.[1]

Southwest grew considerably during the 1990s but the 1990s were also a strong period for the entire airline industry. Southwest differentiated itself for other airlines when it successfully negotiated the industry wide slide following the Sept. 11 attacks in 2001. Southwest was the only major US carrier to maintain its full flight schedule and to have no layoffs during the next several years.[2]

Southwest emerged as a dominant airline from this tumultuous period for several reasons. First, its low price strategy allowed it to maintain and expand its market share after the 1990s demand surplus dwindled. Second, previous positive management-employee relations allowed Southwest to negotiate with its labor force to lower costs. In its history Southwest has only had one labor strike. Third, Southwest has extensive price hedging of fuel that they gained through oil futures that extended through 2009. This has allowed Southwest to largely avoid the increased cost of oil that has devastated many other airlines. Furthermore, in 2004, Southwest began its first domestic codesharing arrangement by negotiating a deal with ATA. Industry experts have speculated that this arrangement has generated $50 million in revenue for Southwest.[3]

Southwest has recently added transcontinental service but its primary focus remains short point to point flights. Currently Southwest serves 61 airports in 31 states with additional cities petitioning to host Southwest every year.[3] Its fleet of 737's now numbers over 400 but its average flight time remains under 2 hours and its plane turnaround at a gate still averages under 20 minutes.[2] By only flying one type of aircraft, Southwest is able to fly a heavier flight schedule than its competitors. This results from the fact that the loading and unloading of Southwest's aircrafts is completely standardized. The equipment operators and pilots only have to learn one set of skills which they used repeatedly. This allows them to develop the ability to instinctively and more efficiently handle the aircrafts. Furthermore, only one type of specialized equipment is required to service and maintain the airplane fleet.

In response to the success Southwest has had with its business model additional airlines have tried to entire its low price, point to point airline market. Airlines such as Jetblue have been developed directly from the Southwest model and have seen positive results. Additionally many legacy airlines have created subsidiary airlines in an attempt to directly compete with Southwest Airline, such as United creating Ted. These new subsidiaries are creating competition for Southwest but they are also cannibalizing sales from the parent airline. Many airlines have attempted to emulate Southwest but Southwest has developed a niche. The key company elements that have allowed Southwest to succeed in the airline industry will be difficult for rival airlines to adopt individually to increase productivity; Southwest has taken its entire history to cultivate those key elements. To begin, Southwest has only Boeing 737s in its fleet. Working a single type of aircraft increased the experience of employees which in turn means that its employees are extremely efficient in the maintenance, piloting, and general use of the Boeing 737. Increased efficiency along with a culture of positive employee participation results in significant cost reductions. This type of culture and infrastructure for an efficiently run low cost, point to point carrier requires time to be copied by other airlines.

Porter's Five Forces

Market Definition

Southwest Airlines is classified by the North American Industrial Classification System (NAICS) as category 4811, "Scheduled Air Transportation." Southwest Airlines operates in two sub-categories, "Scheduled Air Passenger Transportation" (481112) and "Scheduled Air Freight Transportation" (481111) but receives the majority of its revenue from passenger transportation.[4] Further industry analysis divides passenger transportation into sub-categories based on the size of the area serviced by an airline carrier. Southwest Airlines is categorized as a major airline based on its annual revenue but is categorized as a regional airline based on its operational strategy. Southwest Airlines' unique position makes it difficult to ascertain which firms constrain the strategic decision-making of Southwest Airlines. Legacy airlines such as Delta Air Line Inc. AMR Corp. (American Airlines), UAL Corp. (United Airlines), Northwest Airlines Corp., US Airways Group Inc. (USAir), Continental Airlines Inc., and America West Airlines compete with Southwest Airlines but have very different operational strategies.

Instead of the classic hub-and-spoke system used by most major airlines, Southwest Airlines uses a point-to-point system that allows them to cherry-pick the most profitable routes to operate. Southwest Airlines provides service to 61 airports in 31 states with its fleet of 445 Boeing 737s as of October 2005.[5] In terms of annual revenue and available seat-miles (ASM) Southwest outperforms many of the legacy airlines and ranks as one of the largest U.S. airlines. However, Southwest Airlines is also categorized as a regional/discount airline because of its point-to-point operational strategy and discount services. Most regional/discount airlines have only a fraction of the market capitalization of Southwest Airlines. Only Jetblue and AirTran can be categorized with Southwest as both major airlines and discount regional carriers. Both Jetblue and AirTran may be growing as discount carriers but they remain considerably smaller in terms of market capitalization as compared to Southwest Airlines.

Internal Rivalry

The airline industry is characterized by numerous sellers who have very little differentiation in their product. As a result of these factors and the current market conditions, the airline industry is in a very weak position. Currently four of the top ten airlines are in bankruptcy; Delta Airlines Inc, Northwest Airlines Corp., United Airlines and ATA Airlines. Additionally, US Airways Group Inc, only recently emerged from bankruptcy in Sept. 2005. Southwest Airlines was the only airline of the ten largest U.S. carriers to report a profit in 2004.[6] The deterioration of many major airlines' balance sheets is the result of several factors as will be discussed in later sections but it has been compounded by severe price wars during the last five years. The limited differentiation of the product of most major airlines coupled with the increased price sensitivity of consumers has forced the airline industry to use price competition as its primary mode of rivalry. Price competition has eroded profits in the airline industry and significantly reduced the price-cost margins of most major carriers. Additionally, the emergence of discount airlines, such as Southwest Airlines, in the major airline industry has exasperated the already damaging price competition in the industry.

Non-price competition has mostly disappeared from the airline industry because of the extreme price sensitivity of consumers. Many firms have continued to try and differentiate their product through the advertisement of improved passenger service, more comfortable seats or exceptional frequent flyer programs but these programs have largely failed to increase revenue or market share. Even business travelers have become price sensitive, which has removed the primary way airlines had been able to price discriminate. The combined effect of increased consumer price sensitivity in the airline industry has led to increased rivalry. The industry currently has significant excess capacity and because of the perishable nature of their product and high fixed costs most airlines are left in a difficult negotiating position.

Southwest Airlines is in a unique situation since it is one of the principal driving forces in the current price competition. Currently Southwest Airlines has the lowest cost per available seat mile (CASM) of the major airlines. This allows Southwest Airlines to control prices to maintain its profitability level. However, Southwest Airlines CASM has been slowly increasing due to increased labor costs and a decreasing fuel hedge (see "CASM Analysis" for details on Southwest's fuel hedge). The major airlines are attempting to trim their margins and other discount carriers have the potential for even lower CASM as compared to Southwest Airlines.

Entry

The airline industry is a highly consolidated industry with the top ten airlines accounting for over 90% of total U.S. air traffic in 2004. Despite the centralization of industry and the weak earnings of most major airlines, many new carriers have attempted to enter the airline industry in past years. A success story for new airline entrants has been Jetblue who began in 2000 and has shown sizeable profit margins and high load factors. Jetblue has become an exception to the rule. Most new carriers have failed to establish their place in the industry and have halted operations or filed bankruptcy. In the last three years Mesaba Airlines, Transmeridian Airlines, Aloha Airlines, Southeast Airlines, Great Plaines Airlines, and Midway Airlines have all halted operations.[6] Entry for these firms and others into the airline industry is made difficult because of several strong barriers to entry present in the airline industry.

High startup costs may appear to be a major obstacle for new entrants but capital markets have historically been willing to fund new startups in the airline industry despite high failure rate. Capital markets avid interest in the airline industry has recently waned. The massive financial losses experienced by many major airlines in recent years and the lower consumer demand that has occurred in the aftermath of September 11 have resulted in the tightening of the capital markets for the financing of start-ups.[6] However, new industry analysis has predicted a strong change in both industry demand and profitability which could correspond with increased access to capital markets for new airlines. The potential for funding from capital markets and the profitability of some airlines, especially Southwest Airlines, have increased the incentives for new entrants to enter the airline industry.

The most significant barrier to entry that new entrants face is significant post-entry competition from existing major airlines. The typical strategy of new carriers is to pursue regional markets which offer the most profitable routes. In these markets, entrants can often offer lower prices then existing carriers because of lower marginal costs since they have lower labor and maintenance cost. However, the preexisting price competition amongst the major airlines has created a strong incentive for them to preserve their market share. When an entrant competes head to head with an existing major airline, the major airline will lower prices on that route below those of the entrant while maintaining higher fares on its non-competing routes.[6]

There are many barriers to entry in the airline industry but there remains the possibility that new competitors could arise. However, with the current market conditions and the steep experience curve it would take years for a new airline to become a viable competitor to any of the major airlines.

Substitutes and Complements

The airline industry competes with bus, automobile and train travel in the transportation of individuals. The primary substitute for the airline industry is the automobile. The extensive interstate highway system in the U.S. makes it possible to travel virtually anywhere by car. Auto travel dominates short distance travel because of the impractical nature of flying such short distance. However, as distance needed to travel lengthens usage of airlines dramatically increases. In 2004, only 13% of automobile trips were longer than 1000 miles, compared to 75% of airline trips.[6] Trips of extended distance are impractical by automobile and do not provide sufficient cost benefit. A less popular substitute is the intercity railroad transportation. Trains may have many disadvantages but they have considerable cost advantage as compared to airline transportation. Amtrak is the leading intercity railroad operator and has benefited from U.S. government subsidies that allow it to keep prices exceptionally low. The dramatic difference in price allows Amtrak to compete with the airline industry for those customers who have a large price elasticity of demand for airline transportation. Low costs may attract a small percentage of customers away from the airline industry but the slow rate of travel for trains guarantees that the majority of long distance travelers will chose to travel by airplane.

These regional forms of transportation do not represent a direct substitute for the airline industry but they may be a competitive force that regional airlines need to consider.

Southwest Airlines operates a point-to-point destination schedule between regional cities which may also be connected by considerable bus or railroad traffic. Increased wait times at many airports due to increased security means the time advantage gained by using air travel has diminished. Therefore the marginal benefit of using airlines for transport has decreased and the use of train or automobile may become more viable alternatives.

There are many complements to airline travel but it is difficult to determine the magnitude of the relationship. Many services and products related to travel are complements to airline industry such as hotel rooms and car rental prices. The lower the cost of these services and products the greater demand there will be in the airline industry. However, these complements only affect the leisure traveler not the business traveler. The true determinants of demand for airline travel are economic and political factors.

Supplier Power

The airline industry is sensitive to supplier power through three primary inputs; jet-fuel, airframes and labor. The greatest source of increased supplier power has come from the suppliers of jet-fuel. Jet-fuel prices do no perfectly correlate with oil prices but the historical price level of $70.85 for oil reached in 2005, which meant problems for the airline industry. Historically crude oil has averaged around $20/barrel in the U.S. but since it reached its historical high, the price of crude oil has remained above 60$/barrel. Increased “crack spreads” have further worsened the position of the airline industry to its jet-fuel suppliers. The crack spread measures the difference between the cost of a barrel of crude oil and a barrel of jet-fuel. The “crack spread” has traditionally fluctuated between $5 and $10/barrel but spiked to over $60/barrel in the aftermath of Hurricanes Katrina and Rita.[6]

Like the rest of the airline industry Southwest Airlines faces declining margins due to increasing fuel costs but Southwest Airlines has the most extensive price hedge on fuel in the airline industry. Traditionally, many airlines have operated under the assumption that remaining exposed to fuel prices is the norm for the airline industry and therefore acceptable. Discount airlines, such as Southwest and JetBlue, have deviated from that traditional form of thinking. Both airlines now utilized dynamic hedging strategies which allow them to use hedging to control the episodic nature of jet fuel prices by capping higher prices in the future. Southwest currently has an advanced hedging program that is continually trying to determine future cash flows relating to jet fuel prices to optimize their hedges.[7] However, each year Southwest Airlines fuel hedges as a percentage of total fuel consumption decreases. In 2005, Southwest Airlines fuel hedges cover 85% of fuel use but by 2009 they will only cover only 25%.[8] This yearly reduction in hedge coverage will dramatically increase effective costs and cost per available seat mile (CASM) each year. Since low CASM has been the foundation for Southwest Airlines' competitive advantage in the airline industry, the loss of their fuel hedge could pose potential problems for Southwest Airlines.

Current economic conditions have greatly increased the indirect power jet-fuel suppliers have over the airline industry but those same conditions have lessened the supplier power of both airframe manufacturers and labor unions. Only Boeing and Airbus exist as suppliers of commercial airframes for the airline industry. Historically, the high concentration of airframe manufacturers and the limited availability of substitute inputs have allocated Boeing and Airbus significant direct power in price negotiations with the commercial airlines. However, the current weakened economic position of the entire airline industry has altered the industry's bargaining position with Boeing and Airbus. The head-to-head competition of Boeing and Airbus and the large purchase volume of large airlines mean that suppliers are highly sensitive to airlines switching suppliers. For Boeing, Southwest Airlines is currently the largest single purchaser of Boeing 737s. Southwest Airlines' single aircraft strategy may make it reliant on Boeing but Southwest plans to continue to grow their fleet by 25-30 new planes each year. With the comparative weakness of the rest of the industry this may make Boeing dependent on Southwest's continued business.[8]

Labor costs represent the single largest expense for the airline industry. In 2004 labor costs accounted for 34.4% of total revenue and 39.9% of total costs.[6] The majority of airline employees belong to one of the many industry unions. Historically these unions have allowed airline employees to garner premium wages and benefits. However, financial pressure from large pension funds has been responsible for the disruption of many airlines balance sheets and a leading cause of financial difficulty for the airline industry. Many analysts have speculated that the recent wave of bankruptcy filings by major airlines was completed in order to cut labor costs. United Airlines and US Airways have already cancelled their benefit pension plans while in bankruptcy and passed the obligation on to the Pension Benefit Guaranty Corp. (PBGC), a government agency responsible for insuring U.S. corporation pension funds. The risk of further pension cancellations and bankruptcies has resulted in loss of supplier power by unions and widespread concessions on employee compensation. Unions will maintain significant supplier power in the airline industry but the power has recently been reduced and may continue to decline if market conditions do not improve.

Buyer Power

Consumers currently have considerable buyer power over the airline industry. The economic recession beginning in 2000 and the terrorist attacks of Sept. 11, 2001 had a significant negative impact on consumer demand. From their high in 2000, revenue passenger-miles (RPM) have decreased dramatically and though they have rallied recently they remain at a suppressed level [Revenue passenger-miles are an industry measure for consumer demand which is calculated by multiplying the total number of passengers carried by the number of miles flown]. During this period the airline industry did not experience a corresponding drop in available seat-miles (ASM) [Available seat-miles are an industry measure of capacity which is calculated by taking the total number of seat multiplied by the total number of miles flown]. The industry has attempted to reduce ASM (capacity) to react to decreased RPM (demand) but the reaction has not been sufficient which has resulted in lower load factors. Airlines excess capacity and the perishable nature of airplane seats have allowed consumers to exert a tremendous amount of pressure on the price of airline tickets.

The majority of airline consumers are highly price sensitive. Southwest Airlines was the first to offer online reservations but other airlines rapidly followed in order to reduce costs. Additionally, in an attempt to eliminate the commission required for travel agents, airlines such as Northwest Airlines and United invested in a travel website called Orbitz. This centralized site for online reservation eliminated the 3.5% commission for travel agents but its also increased price competition. The introduction of joint travel websites which allow customers to price shop with ease has also greatly increased consumers price sensitivity. Now reservations can be made for most airlines through a travel site such as Orbitz, Expedia, Travelocity or their individual home websites. Only Southwest Airlines and JetBlue do not offer services through joint travel website; they only offer online reservations through their individual websites.

Current market conditions and consumer preferences have made it difficult for airlines to price discriminate. The airline industry previously relied on business travel for price discrimination but with the ease of internet booking virtually all consumers have become price sensitive. The rise in price sensitivity has been compounded by the lack of product differentiation in the airline industry. Consumers are more willing to purchase tickets based solely on price because most have no brand loyalty. The only remaining form of brand loyalty is through passenger reward programs which have to offer generous compensation to maintain consumer loyalty. Consumers have little brand loyalty to low cost carriers such as Southwest Airlines but since they consistently offer the lowest fares, price sensitive consumers repeatedly chose them. Low cost carriers face less buyer power from price sensitive consumer than high cost carriers.

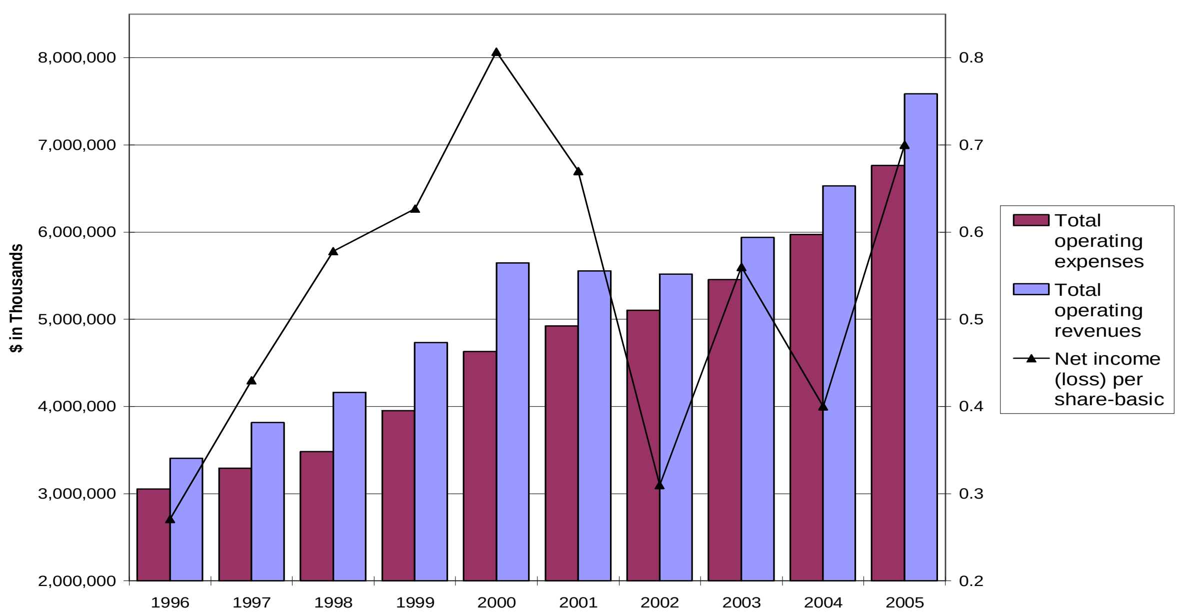
Financial Analysis

Southwest Airlines is currently in a strong financial position, recording its 33rd consecutive profitable year in 2005. Southwest has been able to maintain its strong financial position during the past five years when most airlines have struggled because of its cost advantages. Compared to the industry average, Southwest has a 35 percent cost per available seat mile (CASM) ex-fuel advantage. When Southwest Airlines' extensive fuel-hedging is considered, their cost advantage dramatically increases over other major airlines. Even compared to other discount airlines, Southwest has a cost advantage despite newer discount airlines lower maintenance materials and repairs cost. With its strong balance sheet, low cost structure and low-fares leadership, Southwest remains a strong growth company.

Operation Financials

Southwest's consolidated net income for 2005 was $548 million compared to $313 million in 2004. This represents a 75.1 percent increase. Operating revenues increased by 16.1 percent or $1.1 billion (see Figure 1) due primarily to increased passenger capacity. Increased passenger capacity accounted for almost 70 percent of the increased passenger revenue. In 2005, Southwest Airlines increased passenger capacity by 10.8 percent.[5] Southwest was able to increase capacity so effectively because other airlines scaled back capacity to manage growing buyer power in the airline industry. Southwest was able to utilize the high demand for its low cost service to increase capacity while maintaining high load factors. In 2005, despite increased capacity, load factors reached a record high of 70.7 percent.[5] Increased load factors and increased revenue passenger per passenger further increased passenger revenue.

Figure 1. Southwest EPS, Operating Expenses and Operating Revenues 1996-2005



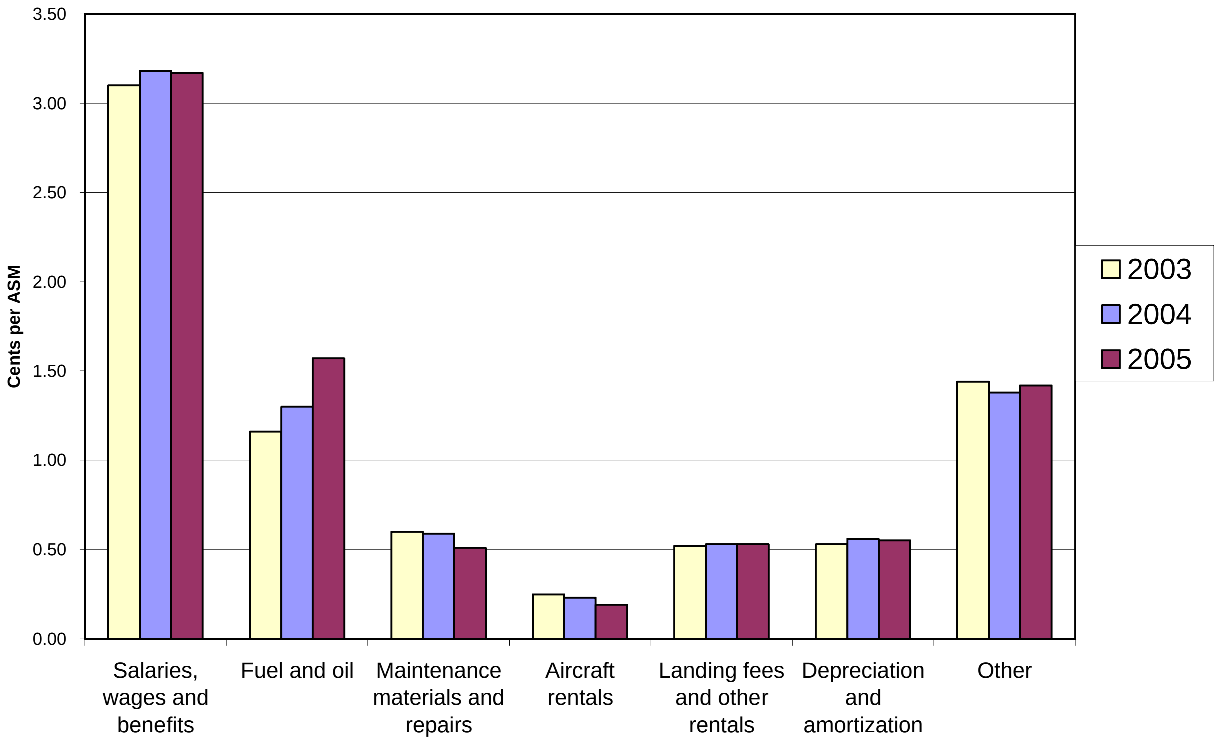
Source: Mergentonline.com.[4]

Southwest Airlines has remained profitable in an industry that has had record setting losses since 2000, nevertheless Southwest has not escaped unscathed. Operating revenues have remained relatively strong and grown significantly in recent years but operating expenses have grown as well. EPS dropped significantly after 2000 and has shown significant volatility since then (see Figure 1). Southwest's inability to maintain a consistent level of EPS and its general low level has concerned some analysts. EPS had reached $.56 in 2003 from a low of $.31 in 2002 but then plummeted to $.40 in 2004. In 2005, EPS finally returned to previous levels seen prior to the Sept. 11, 2001 terrorist attacks when EPS reached $.70. However, earnings in 2003 included $271 million as "other gains" from the Emergency Wartime Supplemental Appropriations Act.[5] The removal of this one time financial support greatly reduces the volatility of EPS and presents a consistent and progressive growth pattern during the past several years. Furthermore, EPS appears to be a primary concern for Southwest Airlines with CEO Herbert D. Kelleher stating that he is intent on achieving further EPS growth of 15 percent in 2006.

CASM Analysis

As mentioned previously, Southwest's financial outcomes are dependent on its low CASM advantage. Southwest Airlines position as one of the lowest CASM has generated the sizable margins that have allowed Southwest to remain flexible and profitable in the tumultuous airline industry. Over the last three years Southwest has generally maintained or lowered costs for all its operating expenses except for fuel and oil (see Figure 2). In 2005, Southwest lowered costs by retiring the last of its Boeing 737-200s and replaced them with new Boeing 737-700s which have provided better fuel efficiency and lower maintenance costs.

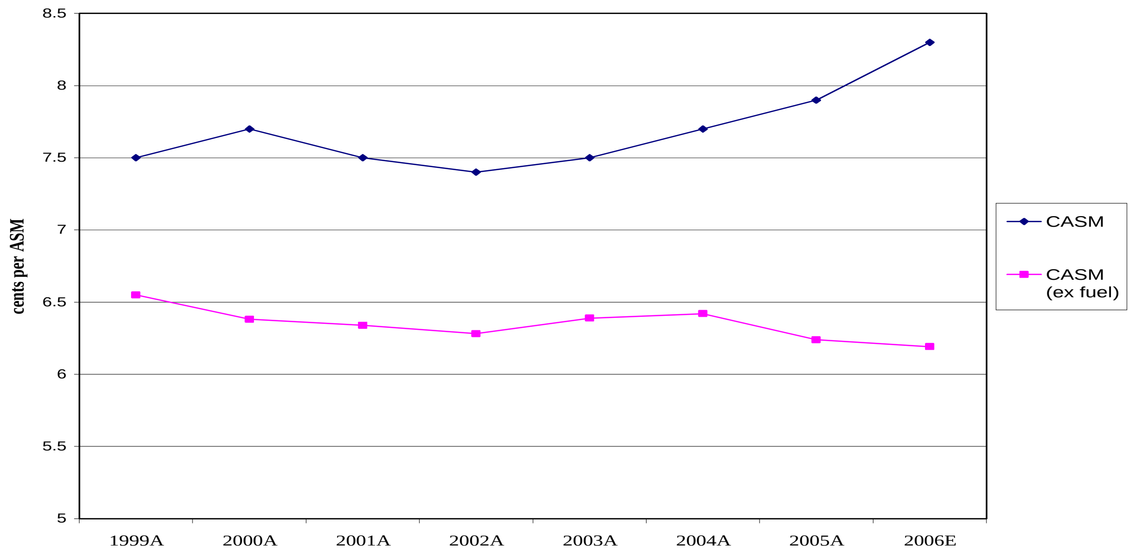
Figure 2. Southwest Cost of Available Seat Miles (CASM) by Operating Expenses



Source: Southwest Airlines 2005 10-K.[5]

Over the last three years operating expenses for fuel increased at a rate which could not be compensated by the reduced CASM ex fuel (see Figure 3). Total CASM has increased since 2002 even as CASM ex fuel has fallen. To compensate for increased fuel costs Southwest improved revenue management and control of non-fuel costs which helped diminish the effect of increased fuel costs on CASM. However, increasing fuel costs have affected the entire airline industry; which means that despite increased total CASM Southwest has increased its cost advantages as a result of its extensive fuel-hedges. Compared to other major airlines or discount carriers Southwest has maintained the lowest CASM (see Table 1).

Figure 3. Southwest Airlines CASM and CASM ex fuel (1999-2006)



Source: Citigroup Analyst Report.[8]

Table 1. CASM Airline Industry	
	CASM
Southwest Airlines (LUV)	7.77¢
Frontier Airlines (FRNT)	8.47
JetBlue (JBLU)	9.00
American Airlines (AMR)	9.73
Jet Airways (JET.BO)	10.9
United Airlines (UAUA)	11.4

Source: Mergent Online.[4]

Table 2. Southwest Fuel-Hedge by Year	
	LUV % Hedged
2005	85%
2006	65%
2007	45%
2008	30%
2009	25%

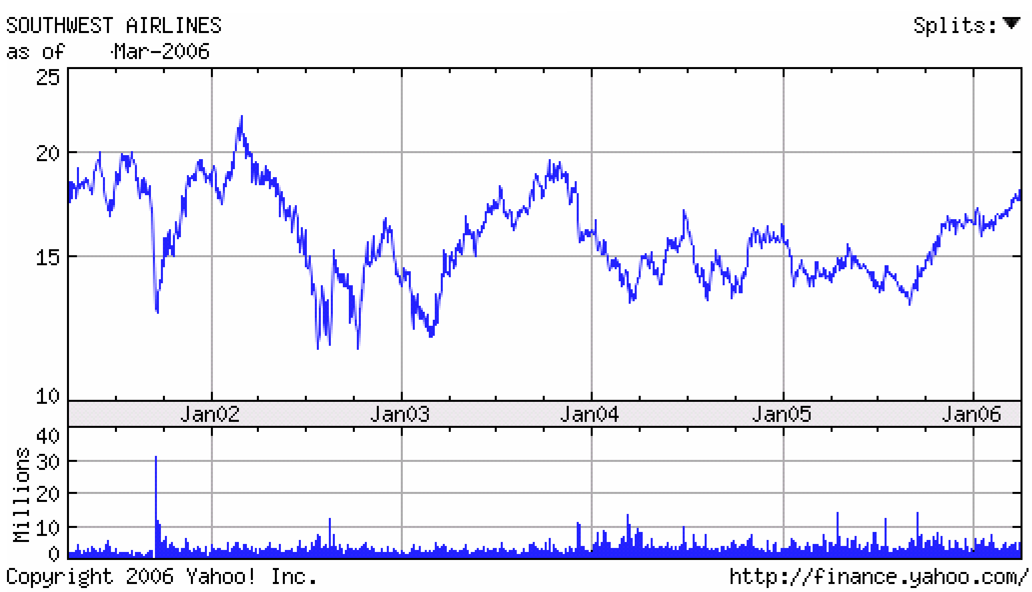
Source: Citigroup Analyst Report.[8]

Southwest has preserved its cost advantages but each year Southwest fuel-hedging erodes until 2010 when they disappear completely (see Table 2). This arouses concern that total CASM will creep even higher which would deteriorate Southwest's competitive advantage. However, many analysts predict margins will actually widen with increased revenue yields, efficiency and cost savings outweighing high expected fuel costs.[9]

Stock Price Valuation

Southwest Airlines stock price has not increased as its operating revenues has in recent years. Over the last five years Southwest's stock has oscillated between $13 and $20 without making any significant or permanent increases (see Figure 3). To explain Southwest's languishing stock, analysts have pointed to significant concerns regarding the entire airline industry, criticisms of creeping CASM and existing share price strength. Many investors believe that Southwest's relative strength in market and growth prospects are already priced into the shares. Since Sept. 2005 the stagnation of Southwest's stock appears to have ceased with the stock increasing over 25 percent in the last 7 months.

Figure 4. Southwest Airline 5 Year Stock Price



In the current market situation it is hard to determine if Southwest Airlines stock valuation is fair. With many major airlines setting records for losses in recent years all forms of valuation by earnings multiples or DCF have been distorted. The earnings situation in the airline industry has deteriorated to the point that most major airlines are unable to report P/E ratios because they have negative earnings (see Table 3).

Table 3. Southwest Airline Market Ratios and Profit

	P/E Ratio	Price to Book Value	Enterprise Value/Revenue	Enterprise Value/EBITDA	Net Profit Margin %
Southwest Airlines (LUV)	26.7	2.16	1.83	10.394	4.01%
AMR Corp. (AMR)	N/A	NA	0.77	12.391	-4.16%
US Airways Group, Inc. (LCC)	N/A	7.66	0.91	N/A	-10.58%
Continental Airlines Inc. (CAL)	N/A	10.3	0.54	11.816	-0.61%
United Airlines (UAUA)	N/A	N/A	0.75	20.676	-121.85%
Delta Air Lines (DALRQ)	N/A	N/A	N/A	N/A	-23.58%
JetBlue Airways Corp. (JBLU)	N/A	2.02	2.17	21.568	-1.18%
AirTran Holdings Inc. (AAI)	950.53	4.53	1.18	48.004	0.12%

Source: Finance.Yahoo.com, Key Statistics.[10]

The metrics that are applicable demonstrate that Southwest may be undervalued compared to other major airlines. Southwest's price/book multiple is the lower than any of the legacy airlines and is comparable to the 2.02x of discount airline JetBlue (see Table 3). Additionally, Southwest is under-priced relative to JetBlue comparing both enterprise value/revenue and enterprise value/EBITDA multiples.

To determine a more accurate valuation, Southwest's current multiples can be compared to historical trading levels for Southwest's stock. Over the period 1994-2005, Southwest had an average P/E ratio of 21.5x. Currently Southwest is trading well above this level at 26.7x. Southwest's current P/E ratio is near its historical average high P/E of 27.7x (Citigroup Analyst Report). However, based on price/book Southwest is undervalued based on historical levels. The average price/book ratio for Southwest since 1990 has been 2.8x which is substantially higher than the current 2.1x price to book value. Using historical multiple as a range, Southwest's stock should be trading between $16 and $25. Currently Southwest is trading at the low end of that range.

Du-Pont Analysis

Du-Pont analysis disaggregates Southwest's ROE into its base components of profit margin, financial leverage and asset turnover. Given current market conditions, a cross industry analysis would provide little relevant information but we can observe Southwest's historical levels and determine operational trends.

Table 3. Southwest Du-Pont Analysis

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
Profit Margin	6.09%	8.33%	10.41%	10.02%	10.68%	9.20%	4.36%	7.44%	4.79%	7.23%
Financial Leverage	0.915	0.899	0.883	0.838	0.847	0.617	0.617	0.601	0.576	0.533
Asset Turnover	2.259	2.114	1.967	1.993	1.932	2.241	2.025	1.955	2.052	2.130
ROE	12.58%	15.82%	18.08%	16.73%	17.47%	12.73%	5.45%	8.75%	5.67%	8.21%

A clear drop in ROE can be observed following 2001 but that was expected due to the depressed market condition at that time. This reduction in ROE was facilitated by a reduction in profit margin, and financial leverage. Following the dramatic drop in 2001, ROE hovered in the 5-9 percent range. Most of the variation in ROE has been due to changes in Southwest's profit margin. From 2000 to 2001, Southwest dramatically decreased its financial leverage and each year thereafter has continued to decrease its dependency on debt. Reducing debt may have been a necessary step at first to reduce risk during the tough market conditions but Southwest's debt to total capitalization is significantly below peer levels. With market conditions improving it may be time for Southwest to take on more risk and increase its financial leverage. If Southwest increases its financial leverage increase ROE and improve its future growth opportunities.

Strategic Issues and Recommendations

Many of Southwest strategic issues can be summarized into two main categories. First, can Southwest maintain its low cost advantages in the airline industry? Second, will Southwest be able to maintain its growth through its current operational strategy?

Maintaining Cost Advantages

Southwest has suffered considerable criticism from the investment world because of increasing CASM. Other discount airlines have entered the market in the attempt to challenge Southwest's dominant position. As CASM increases, Southwest becomes more vulnerable and appears to be losing its most important market advantage. Southwest needs to counter increasing fuel costs with improved non-fuel cost management. The non-fuel costs Southwest needs to focus on are maintenance and labor. Many of the other operational costs will be harder to control but with its current market position, Southwest can take steps now to ensure that it retains its low cost advantage.

Table 4. Southwest Unions and Contracts

Employee Group	**Represented by**	**Agreement Amendable on**
Customer Service and Reservations Agents	International Association of Machinists and Aerospace Workers, AFL-CIO	November 2008 (or 2006 at the Union's option under certain conditions)
Pilots	Southwest Airlines Pilots' Association	September 2006
Ramp, Operations, and Provisioning and Freight Agents	TWU	June 2008 (or 2006 at the Union's option under certain conditions)
Flight Attendants	Transportation Workers of America, AFL-CIO ("TWU")	June 2008

Stock Clerks	International Brotherhood of Teamsters ("Teamsters")	August 2008
Mechanics	AMFA	August 2008
Flight Dispatchers	Southwest Airlines Employee Association	December 2009
Aircraft Appearance Technicians	Aircraft Mechanics Fraternal Association ("AMFA")	February 2009
Flight Simulator Technicians	Teamsters	November 2011
Flight/ Ground School Instructors and Flight Crew Training Instructors	Southwest Airlines Professional Instructors Association	December 2012

Source: Southwest Airlines 2005 10-K.[5]

Over 40 percent of Southwest's total CASM is due to salaries, wages and benefits for a labor force that is over 80 percent unionized. Many of these unions' contracts will become amendable during the next several years. In 2006, Southwest's agreement with the Southwest Airlines Pilots' Association will become amenable. Southwest's contracts with the Association of Machinists and Aerospace Workers (IAM) and the Transportation Workers of America, AFL-CIO (TWU) become amenable in 2008 but their contracts will become amenable during 2006 at the unions' option (see Table 4). Since there are many agreements under consideration over the next few years it is important that Southwest establishes a hard bargaining position from the beginning. If Southwest shows any significant concessions the other unions may take their option to amend their agreement early expecting to receive similar treatment.

The outcome of these agreement negotiations, especially the pilots' union, will have a significant impact on Southwest future cost structure. Southwest is currently in a strong financial position but it must take into account the dramatic reduction in labor costs that are occurring throughout the rest of the industry. Several major airlines have entered bankruptcy with a primary goal of reducing labor costs. These airlines have used government regulations and threat of further financial deterioration to reduce costs. They have streamlined their cost structure by dropping burdensome pension plans and demanding unions agree take pay cuts. Even though Southwest does not have the same financial dilemmas as many other major airlines, Pandora Group believes that it must follow the industry trend and reduce or at least maintain its own labor costs. The unions will resist but the generally weak financial market condition will be a strong bargaining tool for the Southwest.

Furthermore, Southwest has a positive management-employee relationship. Unlike the rest of the airline industry which has been prone to labor strikes, Southwest has had good employee relationships. This positive relationship has been an integral part of the culture that has allowed Southwest to excel in the airline industry. In negotiating new agreements, Southwest should be able to use the established goodwill between management and employees to persuade the unions that maintaining low labor cost are required for the long run stability of the company. However, Southwest must be careful in these negations not to damage the positive management-employee relationship. If Southwest destroys its positive work environment, it would be cutting costs for labor only to have decreased labor efficiency.

Increasing fuel costs will have the greatest effect on CASM but Southwest has no way to directly control the cost of fuel. What Southwest can control is the efficiency with which it uses its fuel. Increased fuel efficiency through the use of newer and better equipped airplanes is the best way Southwest will be able to compensate for increasing fuel costs. Since 2003, Southwest has been adding Blended Winglets to the wings of its aircrafts to help improve fuel efficiency. Pandora Group recommends that Southwest continue that strategy for its older planes but in the long run to purchase new planes to replace the less efficient older models.

Table 5. Firm Orders and Options to Purchase Boeing 737-700 Aircraft

737 Type	Seats	Average Age (Yrs)	Number of Aircraft	Number Owned
-300	137	14.7	194	112
-500	122	14.7	25	16
-700	137	3.8	226	224
Totals		9.1	445	352

Source: Southwest Airlines 2005 10-K. [5]

Southwest has been updating its fleet and has bought more 737-700s than any other airline. This growth has now made Southwest the largest buyer from Boeing. Over the next three years Southwest has firm orders for 67 planes and has options and purchase rights for well over 200 additional planes.[5] Southwest increased passenger capacity by 10.8 percent by purchasing 33 new 737-700s in 2005 and retiring only five old aircraft. Pandora Group recommends that Southwest use its purchasing options and rights to not only increase future passenger capacity but modernize its fleet. Southwest leases over 80 Boeing 737-300s with an average age of 14.7 years (see Table 5). Southwest should use its amassed cash balance and low debt levels to purchase 737-700s or future models as replacements for the relatively fuel inefficient leased 737-300s.

Growth Opportunities

Southwest current operational strategy is to operate point-to-point flights to highly profitable destinations. The strategy has generated strong returns for Southwest but there are concerns about the operational strategy's longer term sustained growth potential. The only means for growth under Southwest current operation strategy is to enter new markets and increase available seat miles (ASM). Southwest has already entered many of the highest demand markets and established its dominance on the most profitable routes. There is concern that as Southwest expands into new markets, those new markets will not be as profitable. Southwest would increase ASM but at the cost of narrowing margins. It is true that Southwest has entered many of the most profitable markets but there remain many other growth opportunities. Pandora Group believes that Southwest should maintain its current operational strategy but with increased attention on gathering market share through aggressive expansion facilitating its low debt levels while the rest of the industry remains relatively weak. Southwest should focus on entering the remaining top 50 cities in which they have no service, increasing presence in existing markets and eventually looking for intra-continental destinations.

Southwest services many parts of the U.S. but they have not entered all of the major U.S. cities. These cities include Atlanta, Minneapolis-St. Paul, San Juan, Cincinnati, Milwaukee, Charlotte, Greensboro and Memphis. Southwest does not provide service to several of these cities because Southwest has avoided mega-hubs of legacy airlines. However, with many legacy carriers struggling now is the time for Southwest to enter these markets and establish its presence. This may already be part of Southwest's strategy. In 2006, Southwest began service in Denver which is the primary hub for United Airlines which had filed for bankruptcy in 2002. With Northwest Airlines recently filing for bankruptcy, Minneapolis-St. Paul represents a similar growth opportunity. In 2005, SkyTrax named the Minneapolis-St. Paul Airport (MSP) as the best airport in North America. However, MSP remains underserved since it is a fortress hub for Northwest which has nearly monopolistic control of the market. Northwest controls nearly 80% of all passenger traffic through MSP with America West, American, Continental, Delta, Frontier, United and US Airways accounting for the rest. With many of the airlines servicing MSP, especially Northwest, experiencing financial difficulty, Pandora Group believes that the Minneapolis-St. Paul airport may be the over-priced and under-served market that Southwest is looking for.

As in Minneapolis-St. Paul, Southwest may be able to use the current weakness of several legacy airlines to their advantage. There remains considerable growth potential for Southwest in cities like Pittsburgh, Philadelphia and Chicago Midway. Cities such as these have been predominantly served by legacy carriers but Southwest has shown that it can challenge these legacy airlines and increase its market share. As other major airlines are forced to decrease capacity, Southwest has been able to quickly increase passenger capacity in these locations. Southwest has already purchased 6 gates at Chicago Midway from the financially troubled ATA in 2004. If ATA should continue to struggle, Southwest may be able to purchase their additional 8 gates.[3] In Baltimore Washington, Philadelphia and Pittsburgh, Southwest has challenged and increased seat capacity against US Airways. In Baltimore Washington, Southwest now controls 40 percent of the seat market. Pandora believes that Southwest needs to use the current market conditions while they still exist to solidify its current position in many cities to support future growth.

The long term solution for Southwest's growth question is to look outside the U.S. for suitable markets. Pandora Group believes Southwest should begin to look for destinations in Canada and Mexico that could be serviced with little change to its current operational strategies. In the past, intra-continental destinations may not have had high enough consumer demand to warrant Southwest's attention but as the airline industry recovers and intra-country airplane travel increases, consumer demand will increase. Additionally, Southwest will need to navigate the subtleties in the laws and regulations of each country but in time Southwest should be able to establish the same efficient operations internationally as it has in the U.S. Finally, the range of the Boeing 737s is not suitable for long-haul international flights but Southwest's current fleet could be easily adapted to service intra-continental destinations. Pandora Group believes this market strategy would allow Southwest to continue its current growth without having to vastly deviate from its current operational strategy.

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