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What's Wrong With American Airlines?

A Critical Financial Analysis

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Introduction

The airline industry has turned the corner after a decade of retrenchment, as second-quarter earnings reports this week are expected to show. The consensus opinion of Wall Street is that all major airlines will report substantial earnings with one exception – American will either break even or suffer a small loss. In the same period last year, American lost $390 million and the year before almost $1.5 billion. Although it may not yet be profitable, American has climbed out of a very deep financial hole.

Based on this record, it is anticipated that Gerard Arpey, American's Chief Executive Officer, will assert in a conference call Wednesday with financial analysts and journalists that the Company is on the right track. He will temper this remark, however, by claiming that American would have realized the same or greater profits than other carriers but for excessive labor costs. He will likely treat this expense as the primary culprit causing the airline's relatively weak performance, while describing the airline's operations as stellar and its "Flight Plan 2020" business plan as on track, if not flawless.

As we show in this report, American's labor costs do not determine its relative profit among its competitors. Its principal deficiencies as an airline are not to be found in the wages and benefits of its rank-and-file workers, but rather in the poor decisions, judgment and vision of the airline's leadership. Unfortunately, its leaders have maintained the same corporate strategy for decades, focusing attention singularly on cost control rather than the opportunities in the industry. This inward focus has caused American to lose its "institutional vigor," suggesting that its current managers are incapable of rejuvenating the airline.

http://blogs.hbr.org/davenport/2010/06/why_cant_americans_business_tr.html

Following management's first quarter earnings report and business plan presentation three months ago, one analyst asked, "Is that all you got?" That question remains and the officers' response, then and now, "We're doing everything right and labor is the source of all our woe," Is simply wrong, as we show in this report.

The Truth

I. Contrary to Its Claim, American's Annual Labor Costs Are Not $600 Million Higher than Its Competitors

In more than two years of negotiations, American has never provided the Association of Professional Flight Attendants (APFA) with any data supporting the company's claim that it suffers a $600 million disadvantage in labor costs. It has given us only a one-page summary of an analysis that allegedly determined the difference in labor costs by applying the wages, benefits and working rules of another airline's employees to the same bargaining unit at American. For example, according to this assessment, if American's Flight Attendants worked under the contract covering United's Flight Attendants, American's costs for the Flight Attendants would be less by a stated amount. However, these conclusions assume that the fleet, routes, staffing, relative seniority, and schedule of American and its competitors are identical. Of course, airlines and unions consider each of these factors in setting their bargaining priorities, tailoring their proposals and establishing the terms of their agreement. Only if American could adjust its operations to match those of its competitors would this analysis have any validity. Because that is an impossible exercise, the claim of a $600 million cost gap is illusory.

Even assuming that American's claim had some validity; the quarterly impact would explain only a $150 million difference in earnings. In fact, most of its competitors are forecast to report profits far exceeding this amount, with Delta expected to earn over $500 million. Nonetheless, American still only blames labor.

II. Filing Bankruptcy Did Not Provide American's Competitors with a Labor Cost Advantage, But by Avoiding Bankruptcy American Preserved and Increased Shareholder Value

The other canard that American will use to deflect senior management's responsibility for the airline's condition and performance is that American is the only major carrier that did not file for bankruptcy protection. Consequently, it will claim that the concessions its competitors extracted from labor were far deeper than those it was able to negotiate.

First, American has presented no evidence that bankruptcy conferred on these airlines a labor cost advantage over American. Second, Mr. Arpey never mentions the benefits of avoiding bankruptcy. While he would readily agree that his principal fiduciary duty as the CEO is to the shareholders, he never acknowledges

that American was the only airline that did not wipe out the entire value of its holdings by not filing for bankruptcy. Rather than extinguish its stock, American was able to preserve the more than $345 million in equity that existed in March 2003 when labor groups consensually agreed to concessions without the involvement of a bankruptcy judge. By June 2007 those same AMR shares were worth more than $11.2 billion, a thirty-two-fold increase in shareholder value.

III. The Labor CASM for American's Flight Attendants Is Very Competitive

As listed on American's own website, Cost per Available Seat Mile ("CASM") is the industry standard for determining costs and productivity. American's Flight Attendant CASM for its domestic operation is the same as or lower than the average for its competitors. While American has the highest international CASM, this is due in large part to its marketing decision to staff international flights with more Flight Attendants than its competitors. With these higher service levels, American realizes the highest international passenger revenue per ASM in the industry and enjoys the largest positive margin between its international RASM and CASM.

IV. The Only Labor Cost that Has Harmed American Is the Compensation Paid to Its Top Officers

In March 2003 senior management told American's employees that the company was on the precipice of bankruptcy and would only avoid this outcome if everyone agreed to substantial labor concessions. In the course of 17 days the three labor unions negotiated cuts in their wages, benefits and work rules that reduced the cost of their collective bargaining agreements by one-third. The thousands of workers who ratified those contracts did so because management promised that everyone at the airline from the lowest to the highest paid would make comparable sacrifices and when the airline recovered, the gains would be apportioned fairly. Within two years the leadership of American Airlines broke those promises by rewarding themselves with salary increases and bonuses, destroying the trust of the rank and file and instilling in them anger that has yet to subside.

In the five-year period from 2003 to 2008, American's top five executives saw their salaries increase by an average of 29.5 percent and their other compensation total an average of $11.4 million. Meanwhile the Flight Attendants in 2010 are paid 10 percent less than they were in 2003. Other than employee morale,

management has sacrificed nothing. Of course, in its presentation, management will not mention the impact its greed and betrayal of employees has had on American's performance.

V. The Leadership's Lack of Vision and Vigor Are the Cause of American's Relatively Weak Financial Results

If the executives ended their routine of blaming labor costs for its relatively weak performance, it would not have to look far to find some of the real causes of its predicament.

Retaining Fuel Inefficient MD-80s

By retaining its huge fleet of MD-80s for as long as it has and not replacing them more rapidly with the far more fuel-efficient 737-800s, management increased American's fuel bill by approximately $1.8 billion over the six-year period from 2004 through 2009.

The average age of the more than 250 MD-80 aircraft that American continues to operate is 19 years. Most of these aircraft were designed and assembled when fuel costs were one-fourth of the current amount. As such, the value of these aircraft on the open market has decreased dramatically, forcing American in 2008 to reduce their carrying value as assets on its balance sheet by more than $1 billion. This recalculation of "recoverable value" also has resulted in a $156 million annual loss in depreciable value.

Slow Movement on Oneworld Anti-Trust Immunity

American and some of its oneworld partners have just obtained anti-trust immunity, which will enable them to more closely coordinate its schedules, pricing and marketing. While it is a significant achievement, it comes 14 years after Delta and United acquired the same benefit for their international alliances. During that time, these immunized relationships generated hundreds of millions of dollars worth of increased traffic, which was borne at the expense of such competitors as American and its oneworld partners. With the recent government approvals for anti-trust immunity, American will begin to rectify this loss of earnings.

Bait and Switch Treatment of AA Workers

AMR executives have been shortsighted in their treatment of American's workforce. While APFA recognizes that our bargaining objectives and perspectives may be very different than those of management, we are all committed to American's success. Profit sharing is one way to promote that common goal. In early 2010 American had a proposal on the table that would have distributed 30 percent of the first $250 million of profits to employees. The proposed formula was the same as Continental's, which at that time was the best in the industry. In mid-February Continental changed its profit-sharing plan to match United's. Virtually on the same day, American withdrew its proposal and replaced it with United's formula, which provided only 15 percent of the first $250 million in earnings to employees. Rather than keep what would have been an industry-leading profit-sharing program and one that clearly aligned the parties' interests, management cut the employee's allocation by as much as 50 percent. [1] American had an opportunity to distinguish itself from its competitors and make up for the years that it had not kept its promise of fairly sharing the company's gains. That realization and response would have required the kind of vigor and vision that this leadership so sorely lacks.

VI. Suggested Questions for Mr. Arpey and the Other Executives Participating in Wednesday's Conference Call

1. How much additional revenue and operating income will anti-trust immunity generate for American Airlines?

2. Why has it taken American 14 years longer to get anti-trust immunity with its alliance partners than it did Delta and United?

3. Do you think management did everything it could to obtain the grant of anti-trust immunity as quickly as possible?

4. How much has American's fuel bill increased because of its retention of the MD-80 and management's failure to replace it with a more fuel-efficient aircraft?

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[1] In American's original proposal, employees would receive 30 percent of any profits up to $250 million, 25 percent of amounts between $250 million and $500 million, and 20 percent of any earnings above $500 million. In the second proposal the employee's share is set at only 15 percent of any and all profits.

5. To APFA's charge that senior management has not shown the vigor or vision needed to operate American, what innovations has the leadership introduced over the past two years?

6. Do you believe your compensation package and those of the other top officers have affected the morale of American's employees?

7. Are you willing to share with us the analysis underlying your claim that American's labor costs are $600 million higher than its competitors?

8. Have you conducted an assessment of APFA's analysis regarding American's Flight Attendant Unit Labor Costs (CASM)? If so, are you willing to share it with us?

9. Is your answer to the question, "Is this all you got." any different on this conference call than it was on the 1st Q call in April?

10. Is it still your goal in these labor negotiations to achieve agreements that are either concessionary or cost-neutral?