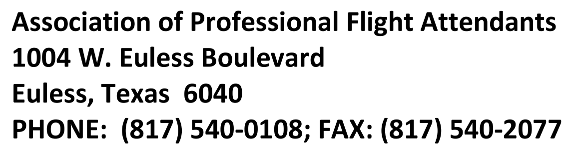
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What's Wrong With American Airlines? Part Two

A Critical Financial Analysis

November 11, 2010

INTRODUCTION

Since the Association of Professional Flight Attendants ("APFA") issued its first White Paper three months ago, the answer to the question it posed – What's wrong with American Airlines? – is substantially clearer. The gap in third quarter performance between AMR and its chief competitors point to problems that are unrelated to its claims about a disadvantage in labor costs or a shortfall in revenue caused by American not having had anti-trust immunity with its international airline partners. Rather, as some Wall Street analysts have recognized, AMR's deficiencies are rooted in its failure to keep pace with the rest of the industry's growth in revenue per available seat mile ("RASM") and top line gross revenue.

In addition, even American concedes that its claim of a labor cost disparity will evaporate over time as other carriers continue to negotiate new collective bargaining agreements that invariably include pay raises and benefit improvements. In fact, Mr. Arpey acknowledged at the 2010 AMR Annual Meeting that negotiations over the next eighteen months will cause labor expenses to converge. As discussed in Section II, recent industry events have not only accelerated this convergence but will soon push the wages of Flight Attendants at other carriers above those at American.

I. THE FIRST ISSUE: The $600 Million Labor Cost Claim

AA's original $600 million claim remains unsupported by the data and model provided to APFA. Shortly after releasing its 2009 results, American's management began to claim its poor performance was due in large part to a labor cost disadvantage versus its competitors. In its Second Quarter SEC 10Q filing American claimed the following;

"*Based on analysis of airline industry labor contracts, the Company estimates that at the beginning of 2010, American's labor cost disadvantage (the amount by which its labor costs exceed what such costs would be if they were determined based on other network carrier labor contracts) was approximately $600 million per year.*" [1]

In January and February 2010, AA developed two separate valuation sheets which supposedly provide the basis for their claimed $600 million annual labor cost disadvantage. Each of these valuations contained a different set of comparative carriers and groupings, and assigned a different cost to some of the same carriers, without showing how such estimates were developed.

As part of its ongoing contract negotiations with American, APFA requested that AA provide supporting data and methodology used to develop these cost assessments. In early September 2010, American agreed to meet with APFA and provide the supporting material for the Flight Attendant's portion of its analysis. Instead of receiving back up for the previous material, AA provided an entirely new set of data which AA claimed was merely an updated version of the previous valuations done in early 2010. While this new material clearly did not provide the backup requested nor comport with the valuations and carrier mix shown in the previous analyses, it did allow APFA to gain an understanding of how AA approached its analysis.

From its review of AA's September analysis, APFA has found that several critical methodological issues completely undermine their basis of their labor cost analysis. AA suggests that if American had the contracts in place at other carriers instead of the ones negotiated with its own labor groups, AA's labor costs would be $600 million (annually) less expensive. AA did not, in fact, apply the contracts from other carriers to AA operations, but rather took individual contract provisions that fit

[1] AMR 2Q 2010 SEC 10Q , page 14.

AA's operations and applied them in a piecemeal fashion, independent of the interaction that clearly occurs. This methodology tends to overstate the cost of AA operations and the savings available from other contracts. If the provisions of other carriers' contracts did not fit AA operations they were assumed to be a no-cost item for the other carrier, even though they have costs associated with them at other carriers.

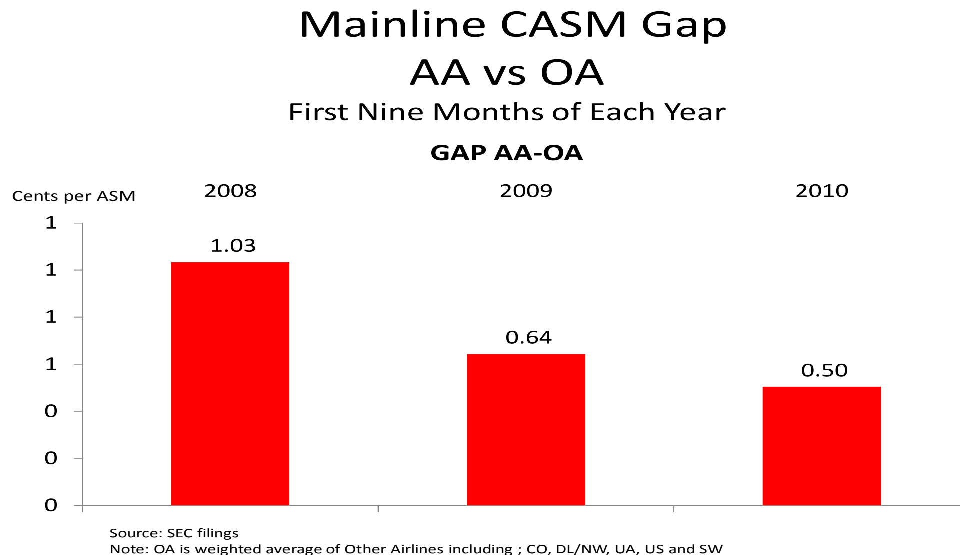
AA's original $600 million claim remains unsupported by the data and model provided to APFA in September 2010. Furthermore, the changing valuations and carrier mix contained in each of AA's three labor cost analyses highlights the difficulty in applying one carrier's contracts to another carrier, rendering such analysis not credible. For example, AA's valuation of Flight Attendant "disadvantage" drops substantially from January to September, with no plausible explanation.

Although many similarities exist among provisions contained in airline labor contracts, each contract has evolved over a long history developed by the unique operational circumstances of each carrier. For American to apply contract provisions independently from each other and to ignore the provisions which do not apply to AA operations renders such an exercise folly and produces a meaningless assessment.

II. THE SECOND ISSUE: The Revenue Gap has Widened as the CASM Gap has Narrowed

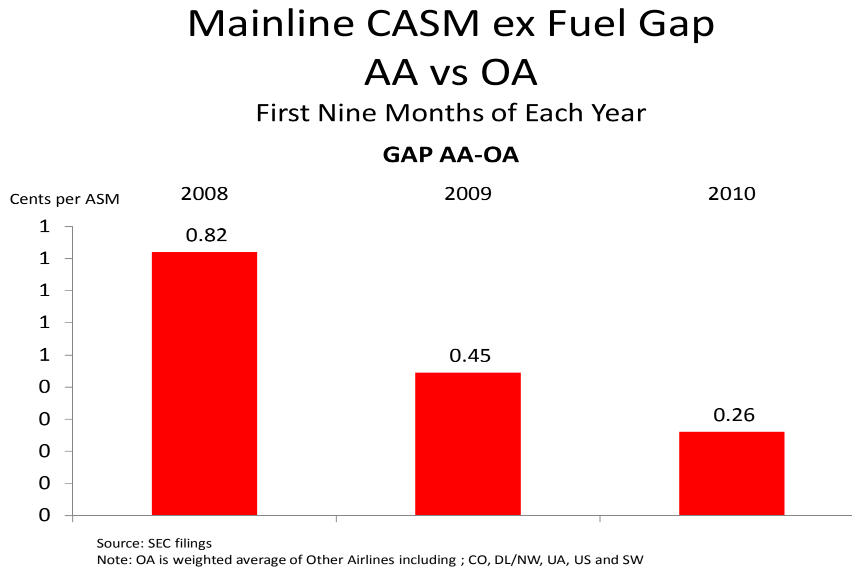
Over the past three years the gap between the profit margin of AA and its competitors has become substantially worse, growing from 1.6% percentage points to 6.1% percentage points. This change, however, cannot be explained by an increasing disparity in costs. As shown in Slide 1, since 2008 American's unit cost gap actually shrunk. In fact, AA's negative differential in CASM in 2009 was 1.03 and by 2010 it was cut in half to .50.

1. Mainline CASM GAP AA vs. OA



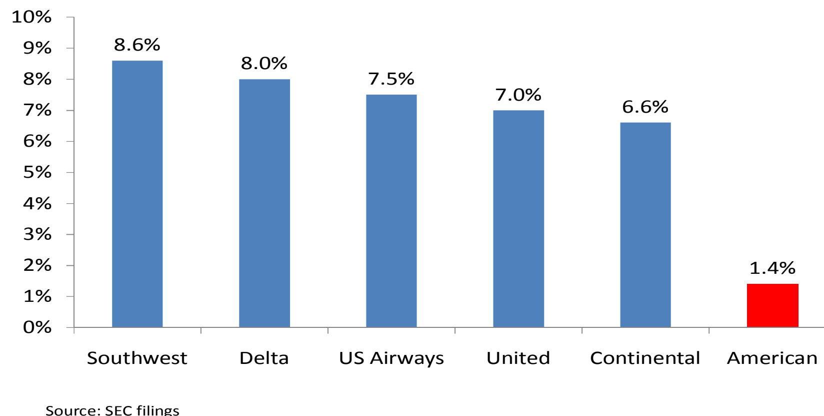
The same is true when comparing total unit costs excluding fuel. As shown in Slide 2, the gap between American and its competitors underwent a substantial reduction during the last three years, from .82 to .26.

2. Mainline CAMS ex Fuel GAP AA vs.



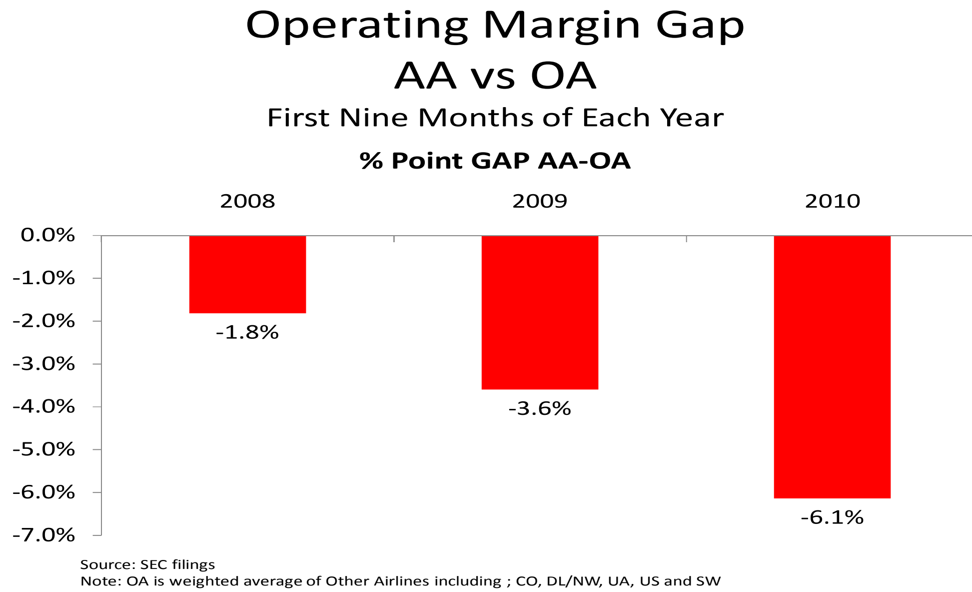
During this period American's competitors grew both unit and top line revenue and thereby achieved substantially better operating profits than they had in 2009. The industry's recent resurgent profitability has resulted in all large carriers reporting positive profit margins for the first nine months of 2010. While American has reported profits as well, its performance greatly lagged its principal competitors by an increasingly wider margin. As Slide 3 demonstrates, American reported a 1.4% operating margin through the first nine months of 2010, which was 6.1 percentage points worse than the average posted by its competitors.

3. Operating Profit Margin First Nine Months 2010



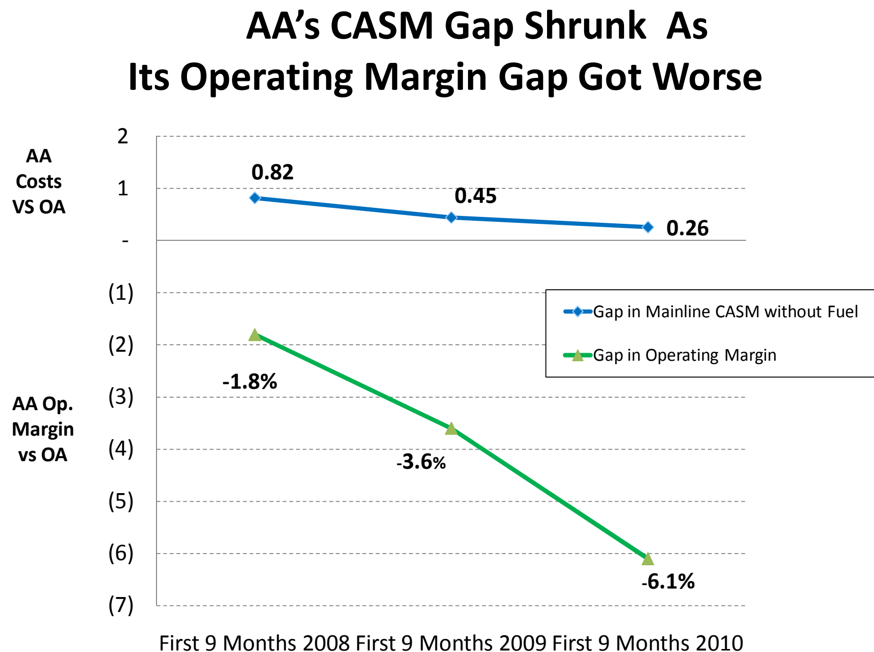
As shown in the next slide, American's lagging profit performance relative to its competitors has become increasingly worse over the past three years (first nine months). In the first nine months of 2008 American lagged the average profit margin by 1.8 %percentage points. The next year this gap doubled to 3.6% percentage point and for the same period in 2010 the margin widened to 6.1%.

4. Operating Margin Gap AA vs. OA



As AA's gap in unit costs decreased, its gap in operating profit should have improved. Slide 5, however, reveals that AA realized no benefit in relative profits even though its comparative costs were substantially reduced.

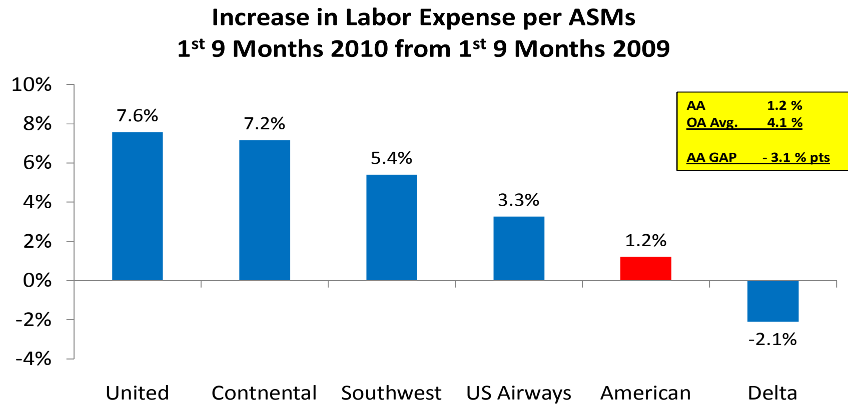
5. Comparison of American Unit Cost (ex fuel) Gap vs Profit Gap.



Comparing the rate of change in the labor costs and operating margins of airlines in the first nine months of 2009 and 2010 further proves American's labor expenses are not the cause of its relatively weak performance. In the first nine months of 2010 American's labor costs have increased by 1.2% over the same period in the previous year. In contrast labor costs for Continental, Delta, United and USAirways rose an average of 3.25%.

6. Labor Unit Cost Change

American's Labor CASM Growth Is Well Below Competitor Average



Source: SEC filings

There is no doubt that American's slipping profit performance gap, whatever its causes, has resulted in lower income for the company's shareholders. As illustrated in the following table, if American had maintained the average profit margin performance of its competitors in the first nine months of 2008, 2009 and 2010 it would have increased its reported operating profits by $333 million, $534 million and $1.0 billion, during those periods, respectively. If on the other hand, American had maintained its 1.8 percentage point gap posted during the first nine months of 2008, it still would have increased its operating profits by $267 million and $720 million in the first nine months of 2009 and 2010, respectively.

7. Quantify amount of money at issue

	2008	**2009**	**2010**
AA Op. Inc. Gap (pts)	-1.8%	-3.6%	-6.1%
AA Op. Inc. (m)	-$1,693	- $614	$240
AA Revenue (m)	$18,297	$14,855	$16,584
Added Inc. if No Gap (m)	$333	$534	$1,011
Added Inc. if Gap -1.8% (m)	-----	$267	$720

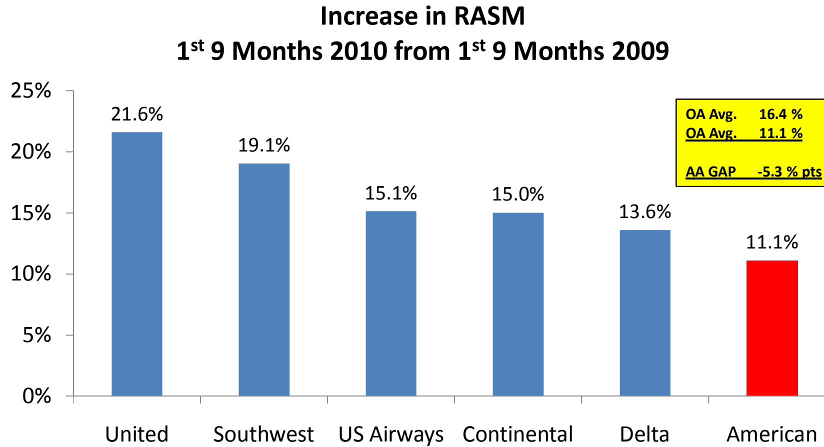
Thus, AA management erroneously blames its costs, and in particular, its labor costs, for an ever expanding gap between its profits and those of its competitors. As the following two slides demonstrate, the blame lies with AA's failure to keep pace with the rest of the industry in revenue growth. That growth among AA's competitors ranged from 13.6% to 21.6%. Their average increase was 16.4%, almost fifty percent better than AA's 11.1%improvement.

8. Increase in Revenue per Available Seat Mile

American's RASM Growth Remains Well Behind Competition

Increase in RASM

1st 9 Months 2010 from 1st 9 Months 2009



Source: SEC filings

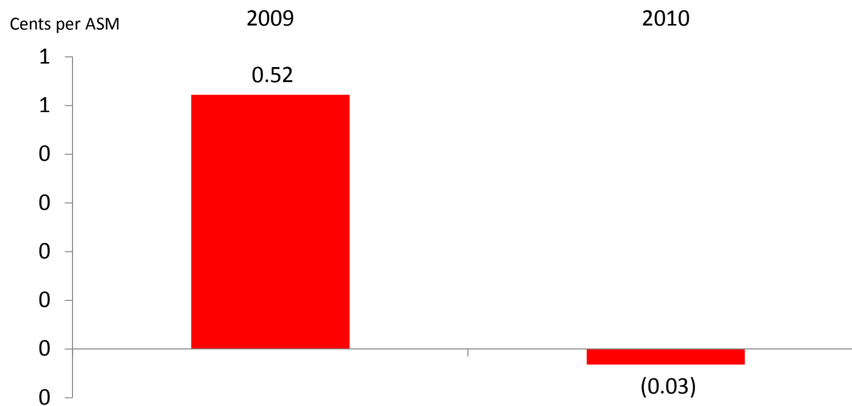
As a result of American's lagging unit revenue growth, it no longer enjoys an average RASM advantage of .52 cents but now suffers a RASM deficit of .03 cents.

9. Mainline RASM GAP AA vs. OA

Consolidated RASM Gap AA vs OA

First Nine Months of Each Year

GAP AA-OA



Source: SEC filings
Note: OA is weighted average of Other Airlines including ; CO, DL/NW, UA, US and SW

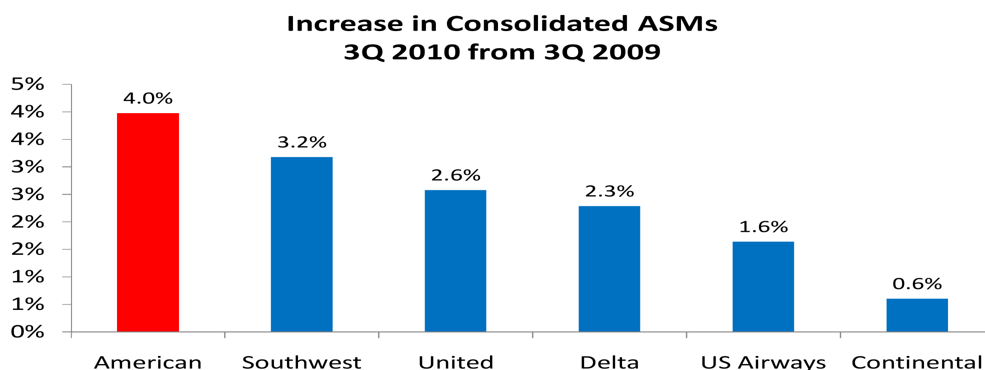
In sum, American is increasingly falling behind the profitability performance levels of all it competitors. The airline's operating margin deficit has more than tripled since the first nine months of

2008 even as its unit costs have become increasingly more competitive. The resurgence in passenger demand has allowed all of its competitors to achieve dramatically higher growth in both unit revenue and top line gross revenues.

Perhaps, after deciding not to participate in the most recent round of consolidation American is starting to lose its competitive leverage. To this end, it is surprising to compare American's industry leading (among larger carriers) 4.0% capacity growth in the first nine months of 2010 as shown in Slide 10. This could help explain both American's diminishing relative unit cost and unit revenue performance, but it does not explain its relatively weak top line revenue growth nor its lagging profit performance.

10. Increase in Total Available Seat Miles

Is Consolidation Forcing American to Defensively Expand Capacity?



Source: SEC filings

Ultimately, the profitability of American will depend on the ability of its managers to position the carrier to increase unit revenue.

III. THE THIRD ISSUE: Labor Cost Convergence

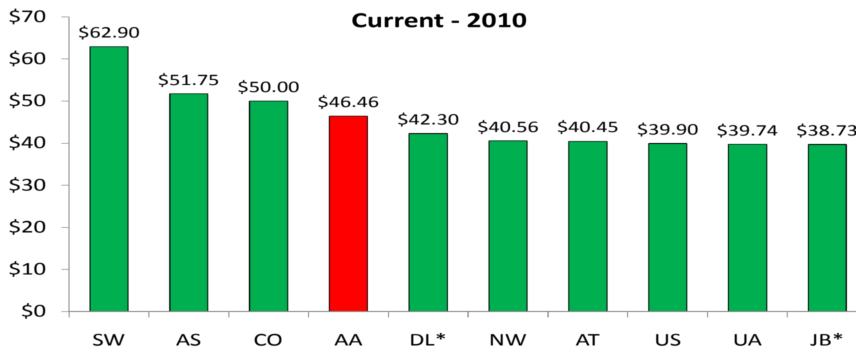
> "*The history of airline mergers suggests . . . that in the process of merging, the labor costs of a combined United/Continental are likely to rise and move towards ours*," Gerard Arpey said.
>
> Moreover, he noted that most industry labor contracts (including American's) are amendable by the end of 2011 or earlier, "*creating more opportunity for cost convergence*."
>
> 2010 AMR Annual Meeting

During the 2010 AMR Annual Meeting CEO Gerard Arpey stated that the labor cost disadvantage that the airline allegedly has with its competitors would narrow over time. Mr. Arpey labeled this phenomenon as "cost convergence" and stated that it would occur as airlines merged and negotiations at other carriers were concluded. What Mr. Arpey did not anticipate was that the consolidation of the industry would take place as rapidly as it has since AMR's Board met less than six months ago. Since then, the Department of Transportation has approved the United-Continental merger and Southwest announced its purchase of AirTran. Considering the effects of these transactions as well as the Delta-Northwest combination, the domestic market will undergo a substantial reallocation and consolidation of flying. Before the Delta merger was completed it took seven carriers to operate 80% of

the market; once the Southwest deal is approved that same level of control will be exercised by just four airlines – Southwest, United, Delta and American with 21.8%, 21.4%, 19.6% and 16.7%, respectively.

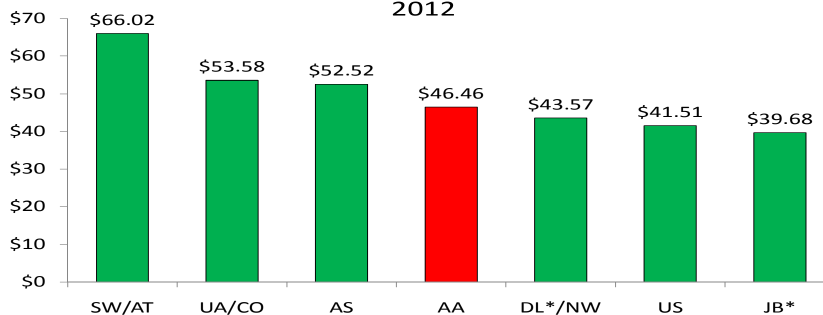
At the same time as fewer carriers are capturing more of the domestic market, these same airlines have negotiated new collective bargaining agreements or raised the wages of their Flight Attendants. Specifically, Southwest signed a new labor contract in the summer of 2009 and Delta increased its Flight Attendant pay effective October 1. In addition, Southwest Flight Attendants are expected to ratify a one year extension of its 2009 CBA which would provide an additional wage increase of 2% next summer and another raise the following year contingent on the company's operating profits. While the Continental Flight Attendants recently rejected a tentative agreement ("TA") that would have increased their wages by 2.5% retroactively to January 1, 2010 and by a total of 7% by the end of 2012, this TA effectively establishes a floor for the pay improvements that will be part of the contract that is ultimately ratified.

11. Current Domestic Top of Scale Flight Attendant Hourly Pay Rates



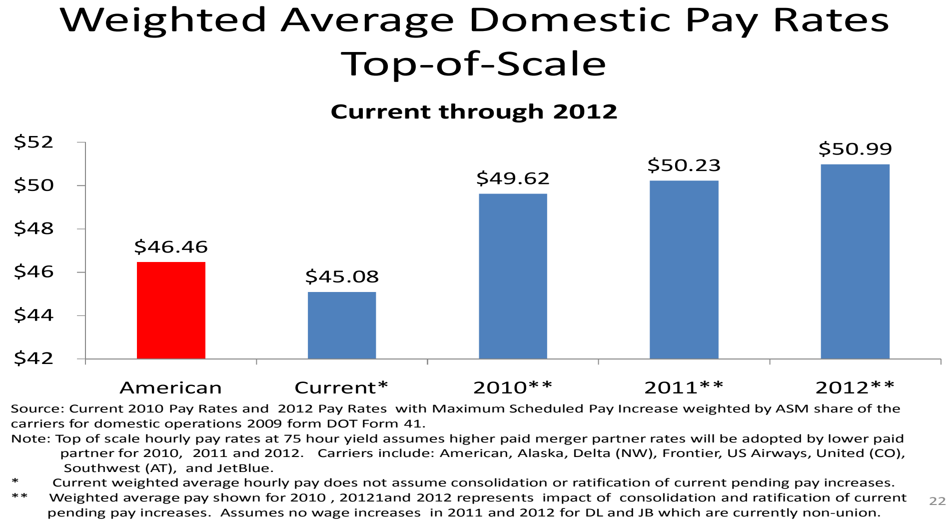
The slide above shows the wage rates in effect prior to October 2010. Slide 12 shows the effect of the revised Southwest agreement and Delta's imposed pay increase. It also treats the rejected wage increases at Continental as the minimum that will be negotiated. Finally, it assumes that in the case of a merger, the pay of the partner that has the higher wage rate will be applied to the combined airline.

12. Domestic Top of Scale Flight Attendant Pay after Increases



Consolidation and new contracts push the wage rates of United and Southwest in 2012 substantially above those of American. The full impact of these changes is revealed in Slide 13 which charts the weighted average domestic pay rates for the next three years.

13. Convergence of Flight Attendant Pay Rates



Without accounting for any of the scheduled increases at other airlines, American's wages exceed the average by 3.1%. However, after the first round of increases at other carriers is implemented by the end of this year and assuming the Continental Flight Attendant wages are increased at least as much as provided for in their rejected tentative agreement, the pay of American's Flight Attendants will lag the industry average by 6.8% and two years later it will fall behind by 9.75%.

It should be noted that the changes in 2011 and 2012 do not assume any increases for Delta and Jet Blue. Both carriers were non-union and any future pay raises were entirely within management's discretion.

IV. THE FOURTH ISSUE: Executive Compensation

The most significant problem that AMR has with labor costs resides not with the pay of its rank and file workers but the compensation of its executives. Seven and one-half years ago the Flight Attendants agreed to concessions that cut the value of their collective bargaining agreement by 30%. As a result their current wages are 10% below their 2003 level. This agreement was predicated on management's pledge that the sacrifices they demanded from the Flight Attendants would be matched by their own, and similarly any gains resulting from these sacrifices would be shared equitably.

Management, however, has repeatedly and shamelessly reneged on its promise. While Flight Attendants remain stuck in the eighth year of what were to be five year concessions executives are reaping tens of million of dollars in bonuses and so-called performance pay. One only needs to consider

the last three years to see that the only performance that correlates with their compensation is the fact that they apparently reported to work. In 2007, 2008 and 2009 the top five officers of AMR received a total of $49 million while the company lost $3.1 billion.