

Liquidation of United Airlines & US Airways is in the Industry's Best Interests

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There has been much speculation in recent weeks over the possibility of a liquidation of both United Airlines and US Airways. With the rejection of United's \$1.6 billion loan guarantee by the Airline Transportation Stabilisation Board (ATSB) on June 17, 2004 (a decision reconfirmed on June 28, 2004 despite United's efforts to secure \$500 million in private equity), the carrier was sent into a tailspin and forced to warn that it would not make \$500 million in pension payments this year. Despite two years of restructuring and cost cutting under Chapter 11 bankruptcy reorganization, United's finances still remain in fragile condition and its business plan offers little hope of the miracle turnaround required to save the second largest carrier and make it competitive. US Airways, though it did secure a \$900 million loan guarantee and a \$1 billion loan from the ATSB, emerged from bankruptcy in March 2003 only to file for Chapter 11 again on September 12, 2004. In the past few weeks, Delta and ATA have also been brought to the verge of Chapter 11 filings, which would result in half the airline industry in bankruptcy. Though these bankruptcies are likely to squeeze more concessions from the labour unions, the liquidation of United and US Airways may actually be a silver lining for an industry that has been plagued by financial turmoil for the last three years.

It is important to recall that the airline industry was facing severe troubles prior to September 11, 2001, with expected losses for the year in excess of \$2 billion. The terrorist attacks brought the industry to a standstill and precipitated a sharp drop in air travel, further compounding the industry's financial woes. September 11 also provided an excuse to provide the industry with federal assistance of up to \$10 billion by way of loan guarantees administered by the ATSB as well as \$5 billion in pretax cash to compensate for the four day government imposed halt to commercial flights. Congress also authorized additional assistance to the industry such as a \$2.3 billion reimbursement for security fees and \$100 million for cockpit door fortification. The total financial relief following September 11 totaled over \$20 billion.

Despite the federal assistance, according to data from the Air Transport Association (ATA), the airline industry reported a net loss of over \$8 billion in 2001, a figure that increased to over \$11

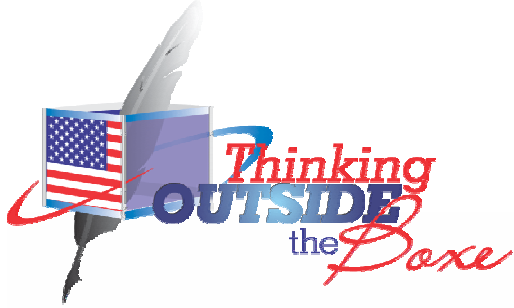
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billion in 2002. From 2001 through 2003, the industry's net losses totaled over \$23 billion—a figure that indicates the industry has no cumulative profits from 1940 to present day. As if these figures were not bad enough, for the first half of 2004, the industry lost nearly \$2 billion. For the third quarter of 2004, American Airlines reported a net loss of \$214 million, Delta reported a net loss of \$646 million, Northwest reported a loss of \$46 million and Continental reported a net loss of \$16 million. Forecasters expect the industry to lose over \$3 billion in 2004 with further losses, perhaps significant, in 2005.

In response to the industry's financial instability, the airlines did their part (to their credit) by cutting an estimated \$10 billion in annual costs from 2001 to 2003. This was accomplished by making 140,000 jobs redundant, cutting flights, dropping unprofitable routes, etc. Despite these efforts and as a result of the continued weakness in air travel along with tremendous losses, many carriers including United, US Airways, Hawaiian, Midway, and Vanguard (to name a few) filed for bankruptcy. Delta and ATA now face possible filings if the financial picture does not improve. However, despite the industry's turbulence during the last three years, many low cost carriers have remained profitable. Southwest, for example, reported a net profit of \$119 million for the third quarter—it's fifty-fourth consecutive quarter of profitability. What is so terribly wrong in the industry that the response following September 11 largely failed to improve the airlines' situation, particularly at United and US Airways? And how have many low cost carriers been able to thrive and put the legacy carriers at such a competitive disadvantage?

The trouble behind many of the airlines' woes, particularly United and US Airways, stems from exorbitant labour costs. Labour, which has been the industry's second fastest growing cost in the last twenty years, currently accounts for roughly 38% of the industry's operating expenses. The bargaining power of the unions has enabled pilots and mechanics to enjoy generous pay increases, such as the 28% immediate one-time raise negotiated for United's pilot in the summer of 2000, benefit packages, and pension plans. This has placed a massive burden on the carriers' finances. Given that low cost carriers are likely to have employees at entry-level salaries and who have not reached retirement age, they have lower labour costs than the legacy carriers with their massive pension obligations. As Caroline Daniel reported in "Airlines Seek Shelter in a Storm" on October 19, 2004, salaries for workers at Delta averaged \$68,698 in 2003 as compared to an average of \$40,972 for the low cost carriers.

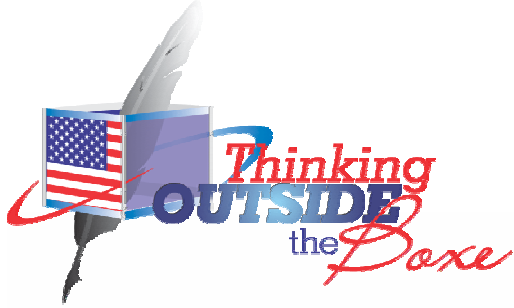
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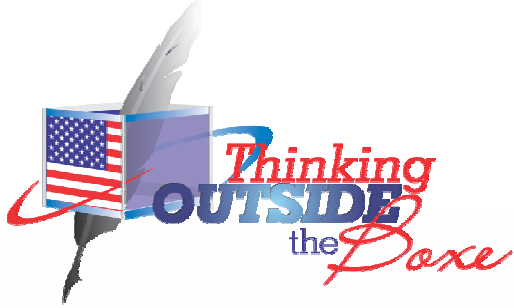
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This disparity in labour costs is highlighted further in the carriers' labour costs per available seat mile. United's labour costs per available seat mile for 2003 was 3.9 cents as compared to 5.2 cents at US Airways, 3.9 cents at Continental, 4.4 cents at American, and 4.6 cents at Delta. These figures are significantly higher than labour cost per available seat mile of 2 cents at Jetblue, 2.3 cents at Airtran, and 3.1 cents at Southwest for 2003. This implies that the legacy carriers are already at a competitive disadvantage versus the low cost carriers.

In addition to having significantly higher labour cost structures, productivity between most low cost carriers and the legacy carriers is dramatically different. The FAA mandates that no pilot may fly commercially more than 1,000 hours in a calendar year, 100 hours in a month, or 30 hours over seven consecutive days. According to the American Bar Association Section of Public Utility, Communications, & Transportation Law *Report of the Aviation Committee* (2003 Spring Council Meeting), Southwest pilots flew an average of 62 hours per month in 2001 as compared to 36 hours per month for pilots at United and 39 hours per month at American. This relatively low productivity environment further compounds the financial problems. In a manufacturing context, this equates to having a machine that can produce up to 1,000 widgets per month but only using the machine to produce 500 widgets per month. When more than 500 widgets are required, the company acquires a new machine to produce the incremental widgets. The economics of this make little sense.

Critics of this entire stance would be quick to point out that labour costs are only one component of a carrier's cost structure. Fuel prices, which are the industry's second highest single cost running between 11-12% of operating expenses, have risen dramatically in the past year with West Texas Intermediate Crude trading well over \$40 per barrel. For an industry that consumes an estimated 18 billion gallons of fuel per year, each \$1 dollar increase in oil prices may cost the industry an additional \$425 million annually according to the ATA. Despite this, oil prices are a constant factor that all airlines in the industry must confront. Effective use of hedging, however, should help protect against any significant rise in oil prices, which have such an adverse effect. By hedging 80% of its fuel needs, Southwest managed to limit the negative effect of rising oil prices during 2004. Though average fuel costs rose roughly 10%, Southwest's third quarter unit costs increased by only 1.3%. Hedging by the legacy carriers could have mitigated the massive losses blamed on rising fuel prices during the third quarter. Failure to hedge



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equates to skydiving without a parachute.

Liquidation of United and US Airways could bring about much-needed industry change with respect to labour and cost structures. First, a liquidation of United and US Airways would force those carriers' passenger traffic to be redistributed to other carriers—both low cost and legacy. This redistribution of over 140 billion revenue passenger miles to the other carriers would significantly boost carrier load factors—a crucial factor in determining a carrier's financial status. In 2003, the industry's load factor was 73.4% with a breakeven load factor of 76.4%. Low cost carrier JetBlue posted a load factor of 84.5% for 2003, well above its own breakeven of 72.5%. Airtran's load factor of 71.1% was also significantly above its own breakeven of 64.1%. Legacy carriers, however, often experienced significantly lower load factors. Delta's 2003 load factor was only 73.3% but breakeven was 77.8%. Passenger load factor at United was 76.5% with a breakeven load factor of 87.6%. US Airways' load factor in 2003 was 73.3% with Continental and American posting load factors of 75.5% and 72.8%, respectively. None of these load factors were above the industry breakeven load factor. With United and US Airways out of the way, Delta, for example, could significantly improve its own load factor to above the breakeven level—assuming it could secure a portion of former customers from United and US Airways. As a whole, the competitors would benefit significantly by improving load factors, which could help the remaining competitors break even and begin to restore financial stability to the industry.

Second, it would provide the industry a valuable opportunity to negotiate with the labour unions for restructuring of labour costs. With the liquidation of United and US Airways, executives at the other legacy carriers could seize upon the opportunity to bring the labour unions to the table to negotiate agreements that provide for both the long-term interests of the carriers as going concerns as well as the employees. Labour unions will have to realize that the overly generous compensation packages of the past decades are likely a creature of the past. Leaner finances would mandate lower labour costs in order to remove the competitive disadvantage of the legacy carriers as compared to the low cost carriers. Since the pendulum previously swung too far in labour's favour, the industry executives should be cautious not to allow the pendulum to swing too far in the other direction. A balanced approach where both parties reach an agreement that is feasible for securing industry stability is certainly preferable to one where either party wields its influence

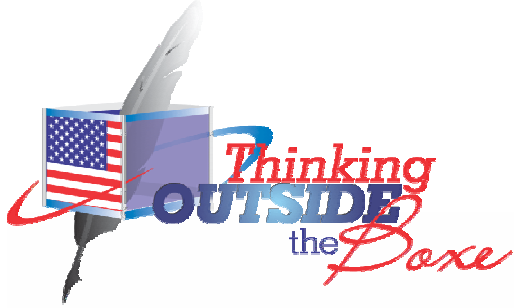
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unreasonably.

Finally, the logistical complexity of air traffic in the United States has typically resulted in delays nationwide, which often leads to irate travelers, as well as an increase in the risk of accidents. These problems result simply from congested skies. Though many airlines have cut flights since September 11, the congestion in the skies would be further alleviated once United's and US Airways' flights were discontinued. Given the excess capacity at other carriers, the increased number of flights (at the other carriers) required to continue to satisfy customers from United and US Airways would be less than the number of flights previously operated by the two liquidated carriers. On-time performance should improve, as flights are not forced to circle an airport several times whilst awaiting clearance to land. As such, customer complaints would likely be reduced by improvements in on-time arrivals and departures. The airlines should be smiling at the prospect of higher customer satisfaction and less disgruntled passengers creating disturbances whilst in the air and on the ground.

Though passengers may be inconvenienced at first by the reduction in the number of flights at some locations, the public should look forward to the possibility of a financially stable airline industry. In the long-term, a healthy airline industry could lead to expansion of flights and routes, improvements in performance, and continued low fares as the price competitive nature of the industry is unlikely to disappear change significantly.

The troubles facing the United States' airline industry may yet precipitate a positive outcome by enabling the industry to become financially stable through a fundamental restructuring. Perhaps it is time to let United and US Airways fly off into the sunset in the best interests of the industry as a whole.