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Keeping American Airways up in the air

- An appeal to learn from past crisis, competitors and the best.

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After the attacks of September 11, 2001, airlines got into serious trouble and were forced to cut costs and routes all over the world quickly. Some airlines in the US that did not have enough financial resources went into Chapter 11 protection in order to cut costs faster than would otherwise be possible. One of the companies that survived this difficult time without such protection was American Airlines.

The US airline market has been consolidating for several years, which is a healthy development. Until recently, there were four big US carriers, which is probably too many for the size of the market, as there might only be two that can operate profitably in the long run. This consolidation is an international development, although it will probably take longer in Europe because some airlines are governmentially backed (AirFrance/KLM, Alitalia) and because Europe consits of many countries with different laws, which stretches the merger process. Still, there are signs that, even in Europe, the consolidation process has begun. Hungarian Malev and Spainair are bankrupt, Olympic is almost there, Alitalia has never been very profitable, and Air Berlin survives only because Ethiad is backing it up financially. In the long run, we will see some substanitial consolidation that might end in Lufthansa's and AirFrance/KLM's dominating the European market.

Even though all big US airlines seem to run into trouble at one time or another, their management does not seem to learn from the industry's mistakes. Compared to non-US airlines like Lufthansa, Singapore, and or Emirates, American's finances are much worse.

Currently, AMR, the group to which American Airlines and American Eagal belong, operates about 900 airplanes, serves more than 250 airports in about 50 countries, and employs about 88,000 employees. In December 2011 alone, the company lost US$ 904 million.

Once a strong airline that survived this serious crisis on its own account, American was forced to file for chapter 11 protection in November 2011. Since it did not use its time and financial power to restructure the company to make it more competitive, its competitors have lower costs and can operate more pro-

fitably. What followed had to happen since American didn't adapt to its competition's lower cost structure. The fleet is much too old, maintenance costs and labor costs are too high to compete efficiently. Therefore they filed for Chapter 11 at the beginning of 2012. In this case, leading the company into Chapter 11 made sense, as it will allow management to renegotiate employees' contracts, which would otherwise be difficult given the traditionally strong unions in the airline industry.

Possible ways out…

US Airways has been looking for a partner for a while because it is at risk of not being able to keep up with other airlines that have merged over the last couple years. A merger could bring significant advantages in terms of providing routes to customers and cost reductions. Currently, US Airways is competing with American on numerous routes, lowering earnings for both of them.

A merger with Delta could be difficult because both American and Delta are (along with United Continental) among the three largest airlines in the US. A merger would probably not be allowed by US Department of Justic (DOJ).

A takeover by TPG would draw the DOJ's attention, and such a takeover would call for some significant restructuring and a risky turnaround plan. However, if it stays alone, American will not be able to profit from the economies of scale it would if it merged with another airline.

American's current CEO, Tom Horton, does not believe that a merger with another airline would benefit American or its shareholders, but I tend to disagree. The stakeholders would certainly profit from a merger if it lifts the airline into first or second place in the list of the largest US airlines. Costs could be cut significantly because most routes are not exclusive to American but shared with a competitor; a merger would end the price war on routes on which the merger partner currently competes with American. Furthermore, less ground personal would be needed, because fewer planes would be necessary to serve the same route; redundancy would be eliminated. A merger would probably be the best strategy for laying off the most employees and chapter 11 does make this step easier than ever. It would be a dramatic step but it would mean the best chances for surviving.

If American continues to go it alone, it will still have to cut costs and workforce without benefiting from the advantages of a merger. It would need to retain redundancy with other airlines with which it shares routes, and it would need to invest sustantially in marketing activities lower its fares, or invest in higher quality service than the competition in order to compete. Furthermore, there would still be no getting around laying off employees—perhaps not as many as would be laid off with a merger, but the remaining employees would have to agree to wages that are likely to be lower than the competition's wages. In any case, all possible strategies would be more cost-intensive than a merger. Even if American could implement a cost structure with lower wages than those of the competition, it would still not be profitable for a long time because of its high-interest debt, a disadvantage that the competion does not share.

So far, I have not seen American pursue a strategy that clearly says how the company

plans to survive its competition and compete in the long run in a highly competitive industry. So far, the actions Horton has taken and the statements he has made lead me to believe that his strategy is mainly about cutting costs. To my knowledge and experience, to achieve a sustainable turnaround it is necessary to pursue a strategy that is different from the one that got the company in trouble in the first place (if there was one…) and different from the competitors' strategies. American will have to be better than the competition, and being better is not only about having lower costs. This is a critical part of American's task going forward, especially if the company does not want to merge.

Horton's current plan is to lay off 13,000 employees (15% of the total workforce), including 2300 flight attendants, and to cut costs by at least 20 percent, or about 2 billion USD. 1.25 billion in savings will result from cutting wages and laying off employees.

This kind of cutting of personnel probably means that there will be fewer attendants on the planes as well and fewer personnel on the ground. However, I cannot help but wonder how Horton expects to keep up the airline's level of service—an important factor in a highly competitive environment—with fewer employees (and more unhappy ones, if wages are cut). Some cuts will have no effect on service because routes will be canceled and planes not be needed, but there will also be cuts where the customers see and feels them. I find this strategy to be questionable in the current situation. In my opinion, there will need to be cuts in the workforce, but there must be compensation for these cuts on other sides, such as by using a much modernized fleet. This compensation for customers is a necessity American won't be able to get around if it wants to stay alive.

The key question here is this: how can American keep up the high maintenance requirements of its old fleet with fewer employees who are likely to be demotivated because of salary cuts? I predict that the good employees in some areas will leave the company to work at the competition's hangar next door, so I see no way that American can keep up the old fleet at the substantially lower costs it would need. Some airline veterans might remember the AirTram ValueJet case, in which lowering maintenance costs, paired with demotivated employees, led to one crash and another near-crash. Therefore, I see it as absolutely necessary to replace the old fleet, possibly by leasing new planes that require less maintenance, less fuel and that can be operated with fewer employees. There are however also signs that the management has learned from some mistakes; in July 2011 American ordered 260 new jets from Boing and Airbus, some of which will be leased. This is a first important step toward reducing costs and improving the customers' experience at the same time. Whether the orders are kept under chapter 11 and whether the planes are available in time is another question.

Over the last few years I have analyzed and plotted turnaround strategies for over 150 insolvency and corporate crisis cases. None of them reached a sustainable turnaround without a clear strategy that set the company apart from its competition, and almost no case survived by cutting costs alone. In my opinion, American needs a clear, holistic turnaround plan that is communicated clearly throughout the company and that leads to a strategic advantage in the industry. Otherwi-

se, American might survive in the short term, even if must merge with a competitor to do so, but it will fall back into trouble in a few years.

To be continued…

About the Author:

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