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Earnings

Net result; operating margin
*ex special items (operating margins all ex SI)

October-December 2011 (3 months)

American: -$1.1b/$209m*; -3%
TAM: $64m/$125m*; 8%
Spirit: $24m; 14%
Norwegian: -$23m; -3%
Kingfisher: -$87m; -$103m*; -33%
Philippine Airlines: -$24m; -11%
Air Mauritius: -$4m; 0%
SkyWest (U.S.): -$18m; 0%

July-December 2011 (6 months)

Qantas: $43m/$198m*; 3%

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Southwest's Kodak Moment?

Amid hints of fading glory, Southwest fights to remain one of America's great corporations

When the first Southwest planes landed in Atlanta last week, some people wondered whether this would be the biggest threat yet to Delta's mighty hub. Others, meanwhile, remembered that the same had been said about US Airways' Philadelphia hub, which Southwest invaded with great fanfare in 2004—only to quietly and gradually reduce service, most recently surrendering the busy Philly-Boston market shortly after also abandoning four others.

People who thought Southwest would have its way in Philadelphia certainly had history on their side: Not only had it obliterated other airlines' hubs throughout the years. It had obliterated *that same airline's hub* at nearby Baltimore-Washington, an airport US Airways dominated a decade earlier.

So for Southwest, will Atlanta be the next Baltimore or the next Philadelphia? And more importantly, what does the answer to that question say about Southwest's future as it faces a number of other strategic challenges?

See also:
- Southwest's top airports, p. 5
- Shrinking profitability gap, p. 6

Among the many differences between Baltimore and Philadelphia, perhaps the most important one is that Southwest just doesn't enjoy nearly the same operating cost advantage over US Airways as it did back in the 1990s. This time, instead of panicking and doubling down by launching a supposed low-cost unit of its own (ill-advised and short-lived MetroJet), US Airways—now with lowish costs of its own—just aggressively matched Southwest's fares. And even so, an *anna.aero* analysis of U.S. DOT data found that US Airways still managed to achieve somewhat higher average fares and far higher load factors than Southwest in competitive Philadelphia markets, which indicates that passengers—especially business travelers—were enjoying Southwest's fares but flying US Airways, where they could expect assigned seats, upgrades, bonus frequent flier miles and so forth. Most business travelers, by the way, don't care whether "bags fly free" or not: many don't even check bags on shorthaul flights, and when they do, either they don't have to pay anyway (because they're elite frequent fliers and the fees are waived) or someone else is

CONTINUED ON p. 6

Pushing Back: Inside This Issue

Take heart, American: bankruptcy did wonders for Japan Airlines, whose newly unveiled business plan features bullish expansion and investment. JAL's latest moves include new B787 routes to San Diego and Helsinki, the purchase of B787-9s to go along with B787-8s and a new partnership with JetBlue. JAL also expects solid profitability in the years to come.

So does JAL's arch-antagonist All Nippon, which is also benefiting from JAL's cathartic downsizing. ANA has a new business plan of its own, one that similarly includes heavy deployment of B787s and aggressive international expansion. The LCC Skymark, meanwhile, is likewise benefiting from JAL's restructuring and the strong Japanese yen, though recent revenue softness and higher fuel prices mean it won't make quite as much money this fiscal year (which ends next month) as originally expected.

Farther south along the Pacific Rim in Indonesia, both Lion Air and Garuda broke out their wallets at the Singapore Airshow. Ethiopian Airlines and Azul were among the show's other plane buyers.

Portugal's economy is struggling mightily, but that's not stopping Emirates from adding Lisbon to its menu of destinations from Dubai. And while Spirit turns heads with its brazen network expansion, it's JetBlue that's quietly becoming a leading force in the corporate-heavy northeast corridor.

Norwegian wants to be the leading force in Scandinavia, with a gargantuan plane order to prove it. But as its latest financial report demonstrated again, it's not a terribly profitable airline. At least not yet. Will longhaul routes be the solution, or will they only exacerbate the problem?❍

"Verbulence

Australian companies like Qantas confront three competitive realities. First is the ongoing reshaping of global finances… Second is the rebalancing of global economic weight to Asia, and particularly China... Third, and largely due to the two previous factors, we confront a profound transition in the Australian economy... Australia has become a very high cost economy in which to do business.

—Qantas CEO Alan Joyce"

Better to make tough changes while times are good. Wait too long, in other words, and you'll wind up like **American**. That's the underlying message advanced by Australia's **Qantas**, which is pushing painful changes in its labor practices (most importantly in maintenance—see page seven) at a time when the company is making money. During the final six months of calendar year 2011, Qantas earned a $43m net profit, or $198m without special items—or $398m excluding a $200m hit from chaotic labor unrest that at one point resulted in the entire airline being grounded. Operating margin was 3%, which was half what it would have been if not for the strikes. Either way, it was less than the 7% operating margin earned during the second half of calendar year 2010, when fuel outlays were 26% less. Revenue for the half rose 6% y/y on 5% more ASK capacity, while total operating costs were up by 9%. For all of calendar year 2011, net profit was $381m ex special items with operating margin at 3%. Once again during the most recent half, some units performed better than others, with the Qantas mainline business (operating margin just 1%) vastly underperforming the **Jetstar** business (9%). The frequent flier program did exceptionally well, and cargo earned solid profits too despite shrinking. But the problem is that mainline still accounts for roughly 70% of the company's revenues, and while domestic markets are performing well, longhaul international markets are troubled. As a result, management is pushing ahead with its controversial labor changes, its intense cost cutting, its exit from loss-making routes (see page eight), its focus on expanding in Asia and its joint ventures with **BA/Iberia**, **American** and **Japan Airlines**. Qantas is also shifting more capital to Jetstar, whose revenues and capacity rose by 15% last half, while significantly cutting capital expenses for mainline aircraft. It still plans a "capital lite" premium airline somewhere in Asia (still no details) and will even slow growth domestically despite booming western markets and the struggles of **Tiger Airways**, not to mention last week's collapse of tiny **Air Australia**. Overall global ASK growth this half (the weaker one in terms of seasonal demand) will be 7%, or 5% adjusting for last year's natural disasters and A380 groundings. Jetstar Japan will launch this summer, Jetstar in Singapore is penetrating China, Jetstar in Australia will get its first B787 next year and Jetstar everywhere sees bullish growth in ancillary revenues (now about $30 per passenger on average). Even when looking at the company as a whole, advance bookings show stronger yields thanks to recent fare hikes, and the bounce back in demand following labor unrest was strikingly (no pun intended) quick. But the vulnerabilities of the large mainline longhaul business are clear and present, exacerbated by weak inbound demand due to the strong Australian dollar—demand from the U.K. and continental Europe is particularly soft. Competition, meanwhile, is intensifying, with Gulf carriers, Chinese carriers and ASEAN LCCs all targeting the Australian market. And so what management wants isn't just another corporate restructuring but a "profound shift in line with paradigm shifts in how the world's economy operates." Qantas overall is fit and healthy. But it needs some preventative care.

American, by contrast, is a sickly patient in intensive care. Its final Q4 figures show the bankrupt airline lost $1.1b net, or $209m ex special items, bringing net loss for all of 2011 to $2b, or $1b ex items. Operating margins for Q4 and last year were negative 3% and negative 2%, respectively, this in a year when every other U.S. airline made money (except probably **Virgin America**, which hasn't yet reported). American's Q4 revenues rose 7% y/y, a bit less than **Delta** but more than **United**. But it actually increased ASM capacity 2% while its two larger rivals shrank. Operating costs, meanwhile, were up 8% for the quarter, even as fuel outlays were up a relatively modest 15%. American also published its annual report last week, which contains some interesting data, including the fact that 40% of its revenues come from international routes, that it now has 69m AAdvantage members, that 65% of the 167b miles it issued last year were sold to third parties including its credit card partner Citigroup, that it ended the year with 608 mainline planes including 200 MD-80s, that its first B787-9 should come in 2014 and that it saved $297m from fuel hedges last year (think how bad things would have been absent that). Now engaged in labor negotiations, management was also quick to note that 85% of senior executive pay is at risk rather than fixed, and that during the past decade, executives earned just half of what they might have had the company made money. Shares they earned became worthless after bankruptcy, and the controversial bonuses that led to the departure of former CEO Don Carty never materialized.

Before long, its blockbuster merger with **LAN** will be complete. But for now, **TAM** is enjoying the aftermath of a solid fourth quarter, one in which its net profit was $64m, or $125m ex special items. Operating margin was 8%. The entire year was pretty good too. Although its official net result was a $205m loss, this was really a $95m net profit excluding forex losses and other special items. Full-year operating margin was 5%. In Q4, TAM continued its strategy of slowing capacity growth, upping ASKs by just 4%, compared to roughly 14% in the first half of the year. That helped boost revenues 11% y/y even as operating expenses rose just 9%, making TAM one of the few airlines that performed better this fourth quarter than last. The conservative capacity approach will continue in 2012, with ASKs to rise no more than 2% domestically and 3% internationally. That's partly in response to a slowing Brazilian economy but also because TAM wants to boost load factors, which tend to be rather low for Brazilian airlines. TAM is also shrinking its domestic narrowbody fleet—all of this despite industry-wide domestic RPK demand that's expected to expand between 8% and 11% this year. TAM, by the way, also notes that 70% of all domestic traffic in Brazil flies from just 10 airports. In the U.S. by contrast, the 10 busiest airports handle just 35% of traffic. In other words, TAM wants to generate more business throughout the vast country. To that end, it is still considering a 31% equity stake in the regional airline **TRIP**. Although Q4 cost pressures increased as the Brazilian real depreciated 6% against the dollar, this phenomenon also helped generate big yield gains on international routes. In the meantime, TAM's ancillary business units—loyalty plan, cargo, maintenance, tour operator—are generating big revenue streams of their own. The airline itself is now implementing new partnerships with **JetBlue** and **Turkish Airlines**, opening sales offices in China, cutting some frequencies to Europe, receiving four new B777-300ERs this year, expanding its distribution outlets and seeing a "quite positive" year ahead. And once joining with LAN, it's likely to defect from the Star Alliance to oneworld.

Back in the U.S., **Spirit Airlines** is a company to watch. While most of its rivals shun growth and raise fares, Spirit is doing the opposite. And in the process, it's earning better profit margins than anyone. During Q4, the ultra-LCC posted a $24m net profit and a 14% operating margin, beating even **Alaska**'s 11% figure. And it remarkably managed to raise revenues (up 27% y/y) more than operating expenses (up 22%) despite much pricier fuel. And such enormous revenue growth came on a mere 5% expansion in ASM capacity, highlighting strong ancillary revenue trends. Passenger unit revenues, too, soared 21%. Success was just as stunning for the full year, which saw Spirit earn a $77m net profit, or $95m ex special items and a 14% operating margin (runner-up Alaska came in at 13%). In the meantime, Spirit's previously shaky balance sheet is strengthening, new planes including A320-NEOs are on order and the network focus is shifting away from Fort Lauderdale and the Caribbean/Latin America to big metro airports like Dallas DFW, Chicago ORD, Las Vegas and now Denver (see page eight). That shift could pose risks to other air-

lines, which might not have low enough costs or resilient enough ancillary revenue streams to do much about it. Spirit says it loves ancillaries in particular because they aren't subject to fare wars, are less price elastic than base fares and often change people's behavior in ways that lower costs (i.e., fees for checked bags lead to fewer checked bags). This might not be for everyone, as Spirit readily admits, but its marketing approach is a compelling one: "the product is our price." In other words, Spirit—like **Ryanair** but unlike most U.S. LCCs—promises only to be cheap, rather than promising some combination of low fares with some amenities.

With a bull's-eye planted squarely on the back of **SAS**, **Norwegian** recently placed firm orders for 222 narrowbodies. Plus it's buying B787s and entering longhaul markets. Plus it grew ASK capacity 21% y/y last quarter. But keep in mind, Norwegian is not **Ryanair** or even **easyJet** in terms of profitability. During Q4, it lost $23m net while posting a negative 3% operating margin. True, that's an off-peak quarter. But for all of 2011, it lost $31m ex special items (official net result was a $21m profit) while operating margin was a measly 2% (compared to 15% for Ryanair)—all after managing just a 2% operating margin in 2010 as well, not good considering that was one of the best years ever for many airlines. Q4 revenues rose 18% y/y as operating expenses rose 20%, mostly driven by a 56% surge in fuel outlays. At the moment, Norwegian gets 12% of its revenue from ancillaries and 38% from domestic flights and has 1.3m members in its frequent flier plan. Key risks for the business include forex trends, heavy seasonality and exposure to LCCs like Ryanair, whose unit costs are lower. But what makes Norwegian salivate are the high unit costs weighing down SAS and also **Finnair**, carriers with hubs in three of Norwegian's key growth markets: Stockholm, Copenhagen and Helsinki. Finnair actually owns a minority stake in Norwegian and was once considered a likely partner. But the two seem to be advancing on adversarial paths. In the meantime, some modestly positive pricing and capacity trends are helping Norwegian's yields, although the airline still plans to slow ASK growth to just 15% this year. A *Bloomberg* interview with its CFO by the way, points to New York, Bangkok, Beijing, Hong Kong, Tokyo, Florida and the U.S. west coast as possible markets for its longhaul operation, which is set to begin next year.

Will **Kingfisher** even be around next year? Or next week, for that matter? Looking like Rocky after fighting Mr. T, the bloodied airline suffered an $87m net loss from October to December, or $103m ex special items. Operating margin was—get this—negative 33%. That was on a 19% y/y decline in revenues, far greater than its 5% ASK capacity reduction. And operating costs were actually up 5% on a 37% spike in fuel outlays. During the same quarter last year, Kingfisher actually made a small operating profit. The network proved an equal opportunity loss-maker, bleeding not just domestically, where the capacity glut is greatest, but even more so on international. In both cases, Kingfisher shrank capacity, but traffic fell by a significantly greater amount, a sign that travelers are booking away. The airline was most recently uninvited from oneworld and continues to have problems coming up with enough cash to pay its workers. India's government is moving on reforms like allowing carriers to import jet fuel from abroad, accept more foreign investment and apply for more international route rights. But it all seems too little, too late for Kingfisher.

Philippine Airlines, in a regulatory filing, showed a $34m net loss for the calendar fourth quarter, which reflects heavy competition and extremely tense labor relations. Operating margin was negative 11%. The latest headache: **Cebu Pacific**'s decision to go longhaul.

LOT Polish suffered a $46m operating loss for all of 2011. That's an improvement on 2010's results but is unlikely to excite potential takeover candidates. The government-controlled airline, which is shopping itself to **Turkish Airlines** and others, blamed high fuel prices, the E.U. economic crisis and currency depreciation for its losses. Management does, however, forecast a $16m profit this year, supported by the arrival of the airline's first two B787s. Separately, LOT unsurprisingly said it's exiting the Warsaw-Hanoi route, a head-scratcher to begin with. In May, though, it will try its luck with Warsaw-Beijing.

Air Mauritius endured a $4m net loss in calendar Q4, while falling just short of break even at the operating level. The carrier, which gets about half of its revenue from European routes, suffered from euro depreciation and wound up growing capacity faster than traffic. To diversify away from markets like France, Air Mauritius recently started flying to Shanghai via Kuala Lumpur and sees Russia as a promising market. Nevertheless, "the situation remains challenging."

The U.S. regional giant **SkyWest**, which flies more than 730 planes for **United** and **Delta**, among others, posted an $18m Q4 net loss and fell just below break even in terms of operating margin. It also lost $27m for all of 2011, marking the company's first annual loss in more than two decades. Its operating margin for 2011, though, was positive 1%. The year was a tough one to manage for SkyWest given its **ExpressJet** integration, the United-**Continental** merger, new contracts with **US Airways** and **Alaska**, the end of a contract with **AirTran** and so on. Its investment in the Brazilian airline **TRIP** also generated losses, as did its investment in Vietnam's **Air Mekong**. At the moment, ExpressJet's costs remain uncompetitive—executives concede they might have underestimated its problems when they acquired it—and an aging fleet means escalating maintenance costs. SkyWest, however, does have an excellent balance sheet, a reputation for good quality and potential opportunities with **American**. It might even use its balance sheet strength to involve itself in the aircraft financing business.

South Africa's **Comair**, which operates a **British Airways** shorthaul franchise and the low-cost carrier **Kulula**, suffered a $4m net loss from July to December. The carrier, which responded with a new restructuring program, is reeling from heavy inflation in two key areas: fuel prices and airport fees. A weakening local currency is another worry. Comair hopes to win more flight rights to nearby international destinations and will soon begin receiving B737-800s, which will help improve fuel efficiency. The company currently operates B737-300s and B737-400s.

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Fleet Sheet

Aircraft Developments

- Picture those ads showing a tired and overweight person on the left, and that same person fit, cheerful and energetic on the right, transformed by dieting and exercise. That's **Japan Airlines**, which barely managed to get out of bed two years ago and now finds itself starting joint ventures, LCCs and new longhaul routes (see SkyMoney at right and page eight). And it's expanding its fleet again. Last week it ordered 20 B787s, this time larger -9 versions. Ten of these 20 are new orders; the rest were converted from dash-eight orders that were already on the books. In total, the now highly profitable JAL has 45 Dreamliners on firm order, 25 -8s and 20 -9s, along with another 20 options. The -9s will start arriving in 2015.
- Airshows, be they in Paris or Farnborough or Dubai, are auspicious venues for announcing new aircraft deals. Last week's Singapore Airshow didn't disappoint, especially for Boeing. America's biggest exporter finalized a monster order announced late last year by Indonesia's **Lion Air**, a hyper-ambitious challenger to government-owned **Garuda**. The deal is for 201 B737-MAX jets plus 29 current-generation B737-900ERs, together with purchase rights for another 150 planes. It all adds up—is this number coincidence or a jab at Airbus?—to 380 aircraft in all.
- And wait, **Lion Air** wasn't done. Along with its desire to link Indonesia to the rest of Asia with narrowbodies, it also wants to enhance air links within Indonesia using turboprops. To that end, Lion's **Wings Air** subsidiary ordered another 27 ATR 72-600s, positioning it to become the largest ATR operator on earth before long. It currently operates 16 ATR 72-500s and will have 60 ATRs in total by 2015. And oh yeah, Lion's founder Rusdi Kirana says he also wants to buy B787s or A330s for a hub in eastern Indonesia. Why not?
- **Garuda** wasn't exactly sitting on its hands at the show. It turned out to be the mystery buyer for the six CRJ-1000s plus 18 options that Bombardier announced one week earlier. Also playing the role of the Riddler was **Ethiopian Airlines**, which turned out to be the mystery buyer of five Q400s. And also buying Q400s—and willing to say it loud and say it proud—was **Alaska Airlines** for its regional unit. Three of those planes ordered by Ethiopian, by the way, will go to its Togo-based **ASKY** unit plying the skies of western Africa.
- Airbus bagged its biggest order at the Singapore Airshow from the Kuwaiti leasing company Alafco. It finalized orders for 35 additional A320-NEOs, bringing its order total to 85. It ordered its first 50 at last year's Dubai Airshow. Airbus separately scored an order for one A319 from **Druk Air**. What in the world is that, you ask? It's the national airline of Bhutan, a remote Himalayan kingdom whose people first got access to television in 1999. Thank goodness for Seinfeld reruns.
- **Azul** might or might not end up looking like a rerun of **JetBlue**, **WestJet** and **Morris Air**, all successful LCCs launched or advised by David Neeleman. For now, anyway, Azul is expanding with confidence and just can't get enough of those 118-seat E195s. The Brazilian LCC firmed options on another 10 units, bringing its total E-Jet order to 62 (including five E190s). About half of these have already been delivered. This could be the year that Azul goes public with its stock, at which point it would begin publishing its financial statements.
- BOC Aviation, owned by the Bank of China, became the 11th buyer of Comac's C919 narrowbody. The lessor will buy 20 units of the 150-seat plane, which is scheduled to enter service in 2016. Most of the buyers are Chinese airlines and leasing companies, although GECAS has some on order as well.

SkyMoney

Airline Finance

- **Japan Airlines** and **All Nippon**, initially crushed by last year's catastrophic tsunami/earthquake/nuclear scare, are currently on top of the world. Both carriers issued bullish profit forecasts and expansion plans for the years ahead, despite pressures from Japan's long-lethargic economy, the country's shrinking population, competition from high-speed rail and LCCs, the European debt crisis, extreme fuel prices and volatile exchange rates. JAL's latest five-year plan (2012 to 2016) includes $6b worth of investments in new planes and products, $650m in cost improvements, further upgrades to safety practices (this was an issue a few years ago), the launch of **Jetstar Japan**, the development of joint ventures with **American** and **British Airways** and plans to enhance its frequent flier plan. It wants to appeal to both Japanese and foreign travelers, aiming for "high quality and full service" on longhaul international flights and "convenience and simplicity" on domestic flights. Target markets include Europe, North America and southeast Asia including India, none of which—from Japan—have exposure to Gulf carriers (contrast that with rivals like **Cathay Pacific** and **Singapore Airlines** based farther south in Asia). Other initiatives include new regional jet deployments from Tokyo Haneda and Osaka Itami, the installation of Wi-Fi on international flights, better premium amenities on Honolulu flights, the pursuit of new partners in the Americas (perhaps **TAM** if it joins oneworld) and new partners in Europe and southeast Asia to foster flow traffic to the Mideast and Africa. It also wants to capture more connecting traffic between North America and East Asia. With this battle plan, JAL hopes to achieve annual operating margins of 10%.
- As for **All Nippon**, it plans to expand international ASKs no less than 22% in the next two years. It's also altering its corporate structure, pursuing new cost-cutting initiatives, developing joint ventures with **United** and **Lufthansa**, backing two new LCCs (**Peach** and **AirAsia Japan**), building its cargo hub in Okinawa and receiving 27 B787s by March 2014, some of them for international markets and others for domestic. It also wants more North America-Asia traffic and expects 7% to 8% annual operating margins in the years to come.
- For all the positive momentum for Japanese airlines—a strong home currency, supply reductions, new airport capacity, etc.—**Skymark** last week lowered its profit forecast for the fiscal year that ends next month. Citing weaker than anticipated revenues and higher fuel prices, the LCC now expects a net profit of about $96m, down from the previous forecast of $110m. Operating margin, meanwhile, is expected to be 19% for the 12 months to March, not 21% as expected earlier. To be sure, these are still great numbers, but the dampened bullishness perhaps indicates weakness for new routes launched from Tokyo Narita and Osaka Kansai. Life won't get any easier for Skymark when **Peach** hits the scene next month, or when **Jetstar Japan** and **AirAsia Japan** make their debut this summer.
- In Hong Kong, meanwhile, **Cathay Pacific** is clearly worried about weakening exports from mainland China, which is hurting its large cargo business. As for the passenger cabins, premium demand is holding up but declining yields in economy class "remain an area of concern."
- **South African Airways** will tell its government owners that it needs more capital (again) after a likely loss this fiscal year, which ends next month. Despite a promising expansion strategy that includes new flights to Beijing and more comprehensive coverage of intra-African markets, SAA's fuel bills are crippling its ability to grow earnings. It also needs additional funds to pursue its idea of linking South America with Asia via Johannesburg. But this won't be its first time asking for a government handout. The airline has received multiple bailouts during the past decade.

AirBuzz

Marketing, Price, Promotion & Alliances

- Does **Japan Airlines** need another partner in Los Angeles and New York? Its joint venture partner **American**, after all, flies from both cities to Tokyo Narita, and will soon resume service to JFK from Tokyo Haneda. Still, Japan Airlines formed a new interline partnership with **JetBlue**, itself a marketing partner with American. The JAL-JetBlue cooperation will also extend to Boston, a city where American has less of a presence, when JAL's B787 flights from Tokyo NRT launch in April.
- **American**, meanwhile—which shares revenue with **JAL** on the three China routes it operates—obtained approval to codeshare with China's **Hainan Airlines**, which operates one route to the U.S. (Beijing-Seattle). American's three China routes are Chicago-Beijing (with notoriously bad slot times), Chicago-Shanghai and Los Angeles-Shanghai. **United**, by the way, serves all three.
- As **American** works to improve its international network, it will also need to improve its international services. That's because larger rivals **United** and **Delta** are using their hefty profits to invest in new inflight amenities. United, for its part, is rebranding its international longhaul premium service as United Global First and United Business First. Improved services like better meals and amenity kits will accompany the name change. It's all part of a plan to spend more than $550m to improve inflight services, an initiative that includes more economy plus seats, flat-bed seats (now on more than 130 planes), larger overhead bins and satellite-enabled Wi-Fi. At the same time, Delta began upgrading its B747s with flat-bed seats in business class, with more than 45 planes in total now equipped with its latest premium product featuring seats configured in a herringbone configuration so that more seats have direct access to the aisle. Delta is also installing slimline economy class seats and outfitting planes with an "economy comfort" section. American has announced some premium service upgrades of its own, though many of the initiatives are for planes (like B777-300ERs) that will be delivered in the future. It recently started serving free beer and wine to economy class passengers on longhaul international flights as well.
- **Emirates**, a prolific advertiser throughout the world, is stepping up its campaigns in the United States. It now has, for example a seven-year deal to sponsor the U.S. Open tennis tournament, which will help boost awareness for its A380 flights from New York JFK. Emirates also serves San Francisco, where it just opened a new airport lounge, along with Los Angeles, Houston, Dallas DFW and—soon—Seattle. Which raises the question: should U.S. airlines like **United**, **Delta** and **American** begin to worry? Without a doubt, some traffic to the Indian subcontinent and the Middle East is at risk, traffic that's a meaningful if not substantial portion of the revenue U.S. carriers share with their European joint venture partners. But they're not nearly as threatened by Gulf carriers as their European peers, which compete with them on nonstop and/or sixth freedom itineraries to Africa, the Indian subcontinent, the Mideast, southeast Asia and Australasia.
- Speaking of airline sports sponsorships, it's important to know that **Delta** is the official sponsor of the New York Knicks basketball team. Why? Because no sports franchise is attracting as much attention right now, meaning Delta is surely getting its money's worth. The reason, in case you haven't heard, is the emerging Chinese-American superstar Jeremy Lin, A New York City sports phenomenon in the vein of Joe Namath, Joe DiMaggio, Mickey Mantle, Reggie Jackson and the entire 1986 Mets featuring the late, great Gary Carter.
- Finally, a note about airline pricing. As oil prices trend upwards yet again, airlines as diverse and widely dispersed as **Japan Airlines**, **Air France** and **Southwest** all raised fares last week, in some cases through higher fuel surcharges.

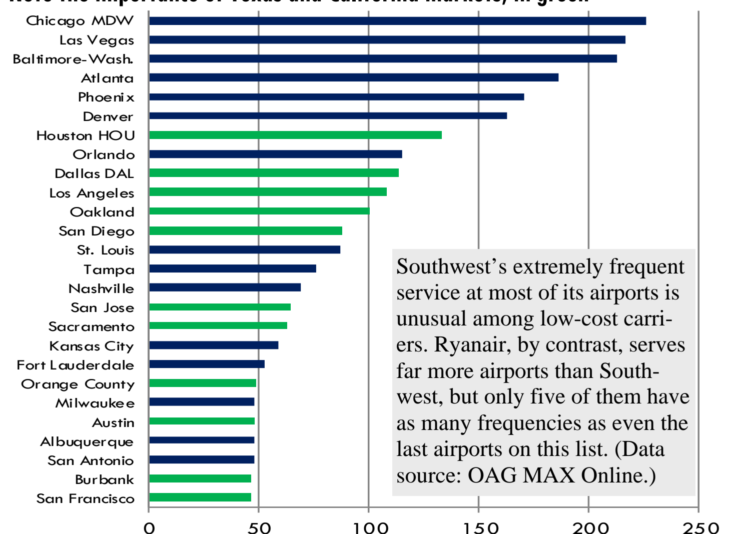
The Backend

Sales, Distribution, Tourism & Corporate Travel

- For all the airline tough talk when it comes to online travel agencies, **United** signed a multi-year deal to continue selling tickets through Orbitz, which is partly owned by Travelport and also operates CheapTickets and other branded websites. The deal also covers Orbitz for Business, an online corporate travel agency that competes against Egencia, Travelocity Business and (less directly) American Express, Carlson Wagonlit, BCD and the like. One other note about this new United-Orbitz announcement: it also includes a pledge to work together on "innovative merchandising and promotional programs designed to maximize exposure for products, services and revenue sources." More and more airline agreements with third-party distributors contain clauses like that, which reflect a desire to sell not just tickets but also ancillary services through travel agencies.
- Orbitz also posted financial results last week, showing net losses for both the fourth quarter and all of 2011. Selling airline tickets rather than generally more profitable hotel rooms remains the largest business activity for the company, but selling airline tickets is growing more and more challenging for OTAs. Orbitz, in fact, saw revenue from standalone airline tickets (it also sells tour packages that include airfare) drop 11% y/y in Q4, although the prior year's figure included some one-time gains. The decline, however, was more importantly driven by higher airfares (OTAs are compensated mostly on ticket volume rather than fares) and moves by airlines to forbid meta-search engines like Kayak and Google from referring transactions to third parties. In other words, Kayak can display **Delta**'s fares, but these days it can only refer shoppers directly to Delta.
- **Southwest**, among the many LCCs with an appetite for more corporate business in an age of high fuel prices, signed an enhanced direct-connect distribution agreement with Egencia, an online corporate travel agency owned by Expedia. The deal brings Egencia's corporate customers improved access to Southwest's fares and inventory, while enabling the inclusion of Southwest bookings in expense and other reports that Egencia generates for clients. Note, however, that Southwest remains a non-participant in Expedia's main online travel agency, which caters mostly to leisure travelers. Southwest doesn't like to be comparison shopped and doesn't play ball with OTA's, period (although **AirTran** does for now).

Southwest's Top Airports

Ranked by average daily departures scheduled this summer; includes AirTran
Note the importance of Texas and California markets, in green



Southwest's extremely frequent service at most of its airports is unusual among low-cost carriers. Ryanair, by contrast, serves far more airports than Southwest, but only five of them have as many frequencies as even the last airports on this list. (Data source: OAG MAX Online.)

Its Best Days Behind It? Southwest no longer competing on an un-level playing field

CONTINUED FROM p. 1

paying.

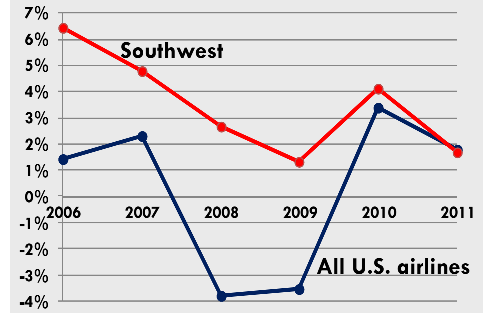
To be clear, the Philadelphia battle has been costly for US Airways—just look at how it is quadrupling some fares as Southwest exits markets, and imagine how much revenue it has lost over the years. But by generating considerably more revenue than Southwest with costs that are now only somewhat higher, it's a battle US Airways could afford to fight while for the most part remaining profitable as a company. This is an important development: for perhaps the first time ever, Southwest, despite the best balance sheet and deepest pockets in the U.S., is losing a war of attrition.

In Atlanta, meanwhile, one major contrast versus Philadelphia or Baltimore is that Southwest was in a sense already there via its subsidiary AirTran, which it purchased, in part, precisely for its Atlanta presence. So the question of how well Southwest will do in Atlanta is not such a mystery. And the answer might not give Southwest much comfort. AirTran had grown into a successful airline, with a sizeable Atlanta hub, under the nose of a once-bumbling Delta that was, at various times, the industry's highest-cost airline and one that wasn't well regarded for knowing how to face competitive threats. In recent years, though, Delta shrank its costs through bankruptcy, grew the airline by acquiring Northwest and, while investing a lot in making its product more customer friendly, took on some of Northwest's famously unfriendly approaches toward competitors. Profits at AirTran—for most of last decade an industry all-star—began to suffer.

Southwest's "new" service in Atlanta will, in fact, just gradually replace AirTran as the latter's fleet and employees transition to Southwest's brand and payroll. Network-wise, a few cities like Austin will come and a few like Miami will go, but for the most part, an airline with assigned seating, a business-class cabin, inflight satellite radio and Wi-Fi on every plane is being replaced by one with open seating, an all-economy cabin (with a bit more legroom), no inflight entertainment and Wi-Fi on—for now—about a quarter of its fleet. Less visibly to customers but critically to the airline, costs will rise as AirTran employees are brought up to Southwest's much higher pay scales. That means Southwest will need higher average fares to profit (especially as it gives up bag-fee revenue), but it might actually have a tougher time than AirTran finding that revenue, not only because of a product that some customers will view as inferior, but also because of how it distributes its inventory. Yes, business travelers are slowly getting better access to Southwest as it distributes through more corporate-friendly GDS channels. But leisure travelers have to call the airline or go directly to southwest.com—a site no one in Atlanta, until now, has had any reason to visit.

Just Another Airline Now

Net profit margin (excluding special items) for the U.S. airline industry and Southwest alone. For the first time in memory, Southwest lagged the industry in 2011.



Source: *Airline Weekly* analysis of company reports

That, by the way, might be another explanation why Southwest had a hard time filling planes between Philadelphia and Boston, two cities where it has only a modest overall presence. If someone living in Albuquerque wants to search just one website for fares, it'll likely be southwest.com. If someone living in Philadelphia or Boston—or Atlanta—wants to search only one site, it almost certainly won't be Southwest's. If Southwest could have one distribution strategy in Albuquerque and another in

CONTINUED ON p. 12

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State of the Unions: Workforce Developments

- **Qantas** is thankfully no **American** when it comes to financial performance. In fact, Qantas is thriving while American wallows in bankruptcy. But both oneworld carriers have at least one challenge in common: outdated maintenance practices. So as American prepares to close one of its three heavy maintenance facilities, Qantas said last week that it also can't justify having three such facilities, one in Melbourne, one in Brisbane and one in Avalon. The airline is now undertaking a review of what exactly to consolidate and where, while in the meantime consolidating some other maintenance functions and improving the efficiency of day-to-day line maintenance. In fact, 500 positions will disappear as a result of the latter two initiatives. Qantas wants to modernize its maintenance practices in a world where current-generation airplanes require less labor-intensive handling, and where many competitors do their labor-intensive heavy checks in countries where the cost of labor is relatively low. But management emphasized it has no intention of offshoring jobs, a controversial issue with labor unions and Australian politicians.
- **Air Canada**'s pilots voted to give their union leaders a mandate to strike if a collective bargaining agreement continues to prove elusive. But threats of an imminent strike were allayed by a deal to accept a plan for six more months of government-mediated negotiations. One of the thorny topics, of course, is the new low-cost unit that management wants to create—and which *The Globe and Mail* reports is already being actively planned.
- With **Iberia** pilots still striking, pilots at Spanish rival **Air Europa** have so far refused to accept a company offer to reduce their pay by 20% in exchange for reducing the number of job cuts. Three other Air Europa unions have agreed to concessions.
- Workers at **United** and **Delta** had some more money to spend on their significant others this Valentine's Day. Both airlines used the occasion to distribute profit-sharing checks to employees, about $265m at each airline. That was equal to about 5% of each worker's annual pay and doesn't include millions in incentive bonuses they earned during the year for achieving things like good on-time performance. Of course, it's important to remember that workers at both airlines had to surrender a lot of pay to enable their employers to reach this point of profitability.
- **Lufthansa** and its passengers were the chief victims of a multi-day strike by air traffic control staff at Frankfurt airport. Fraport, which owns and operates the airport, called the strike "incomprehensible" and the union demands "intransigent and irresponsible." Lufthansa separately welcomed a court decision that upheld its right to hire temporary workers as flight attendants in Berlin, where it plans a big expansion this summer.
- **Thomson Airways**, the U.K.-based airline unit for the travel group **TUI**, recently received the first of 21 single-class B737-800s, all of which will arrive by next summer. The carrier will also start taking B787-8s this year. But it's also phasing out its 22 B757s and 10 B767s, while looking to cut roughly 600 cabin crew jobs. In happier flight attendant news, rival **Virgin Atlantic**, which will launch Cancun and Vancouver service this summer, is currently hiring cabin crew.

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Who's Flying Where

- Proving once again the importance of alliances to modern-day network planning, **Japan Airlines** will send newly arriving B787-8s to Helsinki, home to oneworld partner **Finnair**. But flights won't begin until more than a year from now (March 2013). In the meantime, JAL is also planning to serve San Diego with B787s starting in December, this route less motivated by alliance considerations and more by the simple fact that San Diego has the largest Asian community in the U.S. without nonstop access to Asia. In addition, a number of Japanese companies operate factories in Tijuana just across the Mexican border (potentially bad news, in other words, for **Aeromexico**'s Tijuana-Tokyo nonstops). Both the Helsinki and San Diego routes will operate from Tokyo Narita.
- Armed with precious new airport slots obtained in a recent auction, **JetBlue** is expanding from New York LaGuardia and Washington Reagan, serving two of America's highest income demographics. It's adding three new routes from LaGuardia, all on Florida's Gulf coast—Tampa, Sarasota and Fort Myers—while increasing frequencies to three vacation spots elsewhere in Florida: Orlando, Fort Lauderdale and West Palm Beach. Washington Reagan also gets a new Florida market—Tampa—plus more frequencies to Fort Lauderdale and Orlando. In addition, JetBlue is moving from seven to 10 daily frequencies in the big-money Washington Reagan-Boston market. It's separately adding a new summer-only Boston-Nantucket route as well.
- Also armed with new Reagan slots, in its case obtained via a slot swap with **Delta**, **US Airways** is adding service to Cincinnati, once a thriving Delta regional jet hub, and Des Moines, the state capital of Iowa. CRJ-200s will handle the Cincinnati route, perhaps a rare one where yields will be high enough to cover today's gruesomely high unit costs of a 50-seater. And E190s will handle Des Moines. US Airways says more Washington Reagan route announcements are forthcoming.
- **Emirates** is at it again, undeterred by the gloomy economic news emanating from Europe. The hyper-growth airline is now headed for Lisbon, with B777-200ER flights scheduled to start just six days after it enters another city on the Iberian peninsula: Barcelona. Both services begin in July, with Lisbon becoming the carrier's 31st city in Europe. Spain and Portugal are in deep economic distress, but this also means a growing number of their citizens are traveling abroad for work, many of them to countries reachable via Dubai. The new Dublin route operated by **Emirates**, for example, is undoubtedly filled with the swelling ranks of Irish workers headed for work in Australia. Too bad for Emirates—and thank heaven for **TAP Portugal**—that Dubai doesn't work for connections to Portuguese-speaking Brazil or western Africa.
- **Emirates** separately named Amsterdam, which it only started serving in late 2010, its newest A380 destination. Unlike other A380 operators that only serve a handful of routes with the giant planes, Emirates will soon have 19 cities on the list. Amsterdam will become an A380 market in August, after Tokyo starts seeing the jumbo jets in July.
- In another move to boost the health of its struggling international business, Qantas is dumping service between Singapore and Mumbai, where it faces intense competition, and between Auckland and Los Angeles, a route on which **Air New Zealand** and **Virgin Australia** are working together. Both routes will be gone in May. In addition, Qantas is downsizing its Sydney-Bangkok route from a B747 to an A330 and its Sydney-Auckland route from an A330 to a B737. It's also retiring two additional B747s on top of the four leaving the fleet in April. Tokyo is one market where it's actually increasing capacity, reflecting strong outbound demand from Japanese travelers blessed with a strong local currency.
- **Virgin America** has the sexier image and the better known brand. But **Spirit Airlines** is the true up-and-coming star of the U.S. airline industry. And it's the one other airlines are watching most closely. With low costs, high profits and a business model less subject to the vagaries of base ticket prices, Spirit finds itself feeling more and more like America's version of **Ryanair**, an airline with many more opportunities than it has planes. One of these opportunities is Denver, where Spirit cares little about the three-way battle taking place between **United**, **Southwest** and **Frontier**. It knows that United has much higher costs, that Southwest's fares keep rising and that Frontier is fighting for survival. So starting in May, the ultra-LCC will connect Denver with its four largest crew bases: Fort Lauderdale, Las Vegas, Chicago O'Hare and Dallas-Fort Worth. When asked why they chose Denver, executives also noted that entering such large markets lead to more members for the airline's $9 fare club and more members for its frequent flier program. Separately, Spirit says it has filed for government authority to serve Ecuador, a sign that it hasn't abandoned its original Latin America-focused network strategy. It would also love to fly to Venezuela but can't get flight rights. Venezuela is known to be among **American**'s most profitable country markets, demonstrating that limited competition and oil wealth can make up for an otherwise awfully managed and shrinking economy.
- Give **Spirit** credit for bravely taking on such powerful rivals in such big-money markets. But it's not nearly as brave as **Turkish Airlines**. Türk Hava Yolları, as the airline is known in Turkish, will become the first major airline to serve Mogadishu, the war-ravaged capital of Somalia, arguably the most dangerous country on earth. Flights launching next month will operate twice a week from Istanbul via Khartoum. Turkey's government has dramatically expanded its diplomatic presence in Africa during the past few years, fostering greater economic ties in the process. Turkish, by the way, is also upping its frequencies to New York JFK and Los Angeles, America's two largest cities.
- Bahrain's **Gulf Air**, deeply troubled by ongoing political strife at home and regional political strife more generally, hopes to stem losses by downsizing its network. The carrier—once partly owned by the governments of Abu Dhabi and Qatar before they started their own airlines—hopes to stop its bleeding by exiting Damascus, Athens, Milan and Kuala Lumpur, this after closing Entebbe and Geneva earlier this month. Gulf Air also secured an $80m line of credit from a regional bank, ensuring it doesn't follow **Spanair**, **Malev** and **Air Australia** to the grave, at least for the moment. But the pressure keeps intensifying, with rival **Bahrain Air** announcing another new city last week: Thiruvananthapuram in India.
- **Swiss International**, a prosperous wholly owned subsidiary of **Lufthansa**, launched service from Zurich to Beijing, its third city in greater China. On the other hand, Lufthansa's money-losing **Austrian** subsidiary announced the end of Vienna-Mumbai, a market contested by **Emirates** via Dubai. Austrian will, however, boost frequencies to eastern Europe, as well as to London and Barcelona. It also hopes to pipe more traffic from secondary Austrian cities into the Vienna hub.
- With each passing day, **Hong Kong Airlines** makes life a bit more uncomfortable for **Cathay Pacific** and its **Dragonair** unit. While it's far from challenging Cathay's sterling reputation for service and formidable global network, HKA is one by one adding overlapping routes, including Taiwan routes, which start next month. But its latest new route is Xian, one missing from the Cathay/Dragonair network. HKA also serves a few other

CONTINUED ON p. 9

Who's Flying Where

CONTINUED FROM p. 8

mainland cities that Cathay and Dragonair do not, including Haikou, Guilin and Harbin. It also has **Hainan Airlines** as a mainland equity partner, although Cathay has its own mainland equity partner in **Air China**. HKA also starts its all-premium London Gatwick service next month.

- **Malev**'s demise creates big liabilities for the Hungarian taxpayer and deprives Budapest's airport of connecting traffic. But in terms of total air service for the country, the void is quickly being filled by other airlines, especially LCCs. **Wizz Air**, for its part, followed its announcement of a big Budapest buildup with plans to also serve London Luton from Hungary's second city Debrecen. Flights start in June.
- **Caribbean Airlines** stated its intent to serve London Gatwick from Port of Spain using B767s, having just launched new flights to neighboring St. Lucia. It also stated recently that it's exploring a comprehensive partnership with **Air India**, of all carriers. Next it's going to ask Jabba the Hutt to be its tennis partner.
- Tight credit, suffocating taxation, consolidated competitors and extreme fuel prices notwithstanding, some entrepreneurs insist they've got the seeds to a successful airline startup. The original founders of pre-merger **Vueling**, for example, are launching a new carrier aiming to connect small- and medium-sized cities in Europe. **Volotea**, as its called, will start flying from Venice in April using three 125-seat B717s, a plane with questionable economics at a time of $100-plus oil. Volotea says it won't be competing against LCCs but instead against connecting flights and trains. And while markets haven't yet been named, it intends to have 10 routes operating initially, growing to as many as 25 by the summer. It also claims to be well capitalized.
- As tenuous as that may seem, it sounds like Google, as great business ideas go, compared to a U.S. startup that hopes to re-launch the **People Express** brand. Media reports indicate a model based on re-hubbing Pittsburgh, an old **US Airways** stronghold.

JetGreen

Environment, Conservation & Fuel

- Airbus, IATA, airline CEOs and others took a swipe at the E.U.'s inclusion of non-E.U. airlines in its Emissions Trading System (ETS). Airbus CEO Tom Enders said he's "very worried" the issue could burgeon into a trade war—one in which his company might be a vulnerable, strategic target. And **Etihad** became the latest airline—joining **Ryanair**, **Delta**, **United**, **US Airways** and **American**—to tack on a price increase because of the ETS. The Abu Dhabi carrier is adding $3 to its fuel surcharge on flights in and out of Europe. Alongside the announcement of the price hike, Etihad CEO James Hogan remarked at how the airline is still being punished despite having one of the newest, most fuel-efficient fleets on the planet. IATA Director General and CEO Tony Tyler continued to call on Europe to call it off, and says he's hopeful that a settlement could be brokered by ICAO. But all these suggestions appear to be falling on deaf ears. Siim Kallas, the European commissioner for transport, spelled it out in a *Reuters* interview: "Europe will implement its system with difficulties, with conflicts, with court cases—whatever, the system will be introduced." And if it seemed that the world's governments that oppose the ETS were bashing the scheme less fiercely last week, that hiatus won't last. This week more than two dozen governments will meet in Moscow to presumably hash out steps to stop the ETS.
- There's encouraging—perhaps stunning—news from the biofuels front. A report on aviation biofuels from Bloomberg New Energy Finance, an investor research company, offers a ray of hope that some second-generation bio-jet fuels could be price competitive as soon as 2018. Feedstocks such as camelina, jatropha and cellulose should lead the way. The report says that once under mass production, jatropha could reach a price of $.86/liter ($3.26/gallon). In terms of price competitiveness, algae is still far away, according to the report, and some other feedstocks such as rapeseed, soybean and palm oils might never be viable. Supposing this forecast proves correct, it's heartening to hear that bio-jet fuel could work economically, and it leaves just one more challenge to solve: How do you reach mass production and mature an industry on the mere promise that the product will one day be price competitive? The report suggests government subsidies would help here.

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Around the World

A Look at the World's Airlines, Including Endweek Equity Prices

Airline	Share Price	Change from last week	Change from last year	Comment
United	23.50	-1%	-13%	B787 in United livery forms the backdrop for a speech in Seattle by President Obama
Delta	10.85	0%	-6%	First route with upgraded B747s: Detroit-Narita, a market re-energized by auto sector revival
American	0.54	-10%	-93%	BA/Iberia dismisses the idea of contributing capital to its turnaround (*Bloomberg News*)
US Airways	8.90	1%	-8%	Has examined the wisdom of densifying planes with slimline seats; no current plans to do so
Southwest	9.47	-2%	-25%	Initiated another fare hike last week; might be opening doors for Spirit and perhaps Allegiant
Alaska	76.38	3%	19%	Longtime CEO Bill Ayer retiring; will be replaced by mainline unit president Brad Tilden
JetBlue	5.90	1%	-3%	Philadelphia a conspicuous hole in its otherwise strong northeast corridor network
Spirit	19.82	8%	x	Runway expansion project in Fort Lauderdale will impact its operations later this year
Allegiant	55.51	3%	26%	North Dakota, site of an oil boom, seeing enormous air traffic growth
SkyWest	12.94	-2%	-18%	Post United-Continental merger, more flying was given to ExpressJet; created cost pressures
Republic/Frontier	5.72	-3%	-14%	U.S. regional carriers closely watching for potential new business from American
Pinnacle	1.36	-5%	-80%	New pilot rest rules announced recently by the FAA to take effect in January 2014
Air Canada	1.04	-5%	-68%	Maintenance costs set to rise as many B777s and E190s come off manufacturer warranty
WestJet	13.95	5%	-7%	Rival Porter Airlines starting its own package vacations unit
Aeromexico	25.00	2%	x	January ASK capacity up 7% y/y but RPK traffic up 11%; int'l RPKs up 15%
LAN	21.14	7%	2%	Regulators in Argentina, which still restrict what airlines can charge, authorize fare increase
TAM	41.35	8%	14%	2012 will mark the first time since 2003 that it's reducing its domestic fleet
Gol	8.85	22%	-38%	January yields up 4% y/y; believes upward trend will continue as carriers restrain growth
Copa	76.02	6%	34%	Points to South America-Caribbean as a fast growing leisure market
AviancaTaca	4395	8%	x	TACA increased capacity on the Lima-Santa Cruz (Bolivia) route this month
Emirates	(not publicly traded)			Upcoming route launches: Seattle, Ho Chi Minh City, Barcelona and Lisbon
Air Arabia	0.67	3%	-17%	AirAsia making some noise about possibly launching a rival LCC in the Arabian Gulf
Turkish Airlines	2.76	5%	-45%	Still growing fast: pax counts in January up by 21% y/y; int'l premium pax up 47%
Kenya Airways	17.90	-3%	-56%	Will eventually use B787s on its Nairobi-Dubai route
South African Air.	(not publicly traded)			Rival 1Time now flying from Lanseria airport near Jo'burg; will launch Mombasa March 5
Jet Airways	329	1%	-34%	Not immune to liquidity stress affecting nearly all Indian carriers
Aeroflot	1.77	10%	-29%	Rival S7 launching service from Russia's Far East to Tokyo Narita
Crude oil futures (WTI, for delivery next month; source New York Mercantile exchange)	$103	5%	20%	*Wall Street Journal* story warns that rising oil prices—yes, they're rising again—threaten the U.S. economic recovery. U.S. economic performance during the past six decades (not to mention the outcomes of presidential elections) highly correlated to oil price trends.

Some stocks traded on multiple exchanges; not intended for trading purposes

Around the World

A Look at the World's Airlines, Including Endweek Equity Prices

Airline	Share Price	Change from last week	Change from last year	Comment
Lufthansa	10.85	1%	-31%	Will discuss a new profit improvement program when it reports financial results March 15
Air France/KLM	4.78	-2%	-62%	Scaling back ambitions for Nice and Toulouse bases; launching fewer routes than planned
BA/Iberia	171	-4%	-31%	New BA ad campaign emphasizing its sponsorship of this summer's London Olympics
SAS	8.05	-2%	-65%	Antitrust ban on offering miles for certain Norway routes being lifted
Alitalia	(not publicly traded)			Names a former telecom executive as its new CEO
Finnair	2.48	0%	-45%	All these new Asian flights a big boost for the Finnish economy
Aer Lingus	0.93	0%	-8%	Air Canada bringing back Toronto-Dublin route this summer
Virgin Atlantic	(not publicly traded)			Takes its appeal against BA's purchase of British Midland to the European Commission
easyJet	475	4%	23%	Says it often likes working with airports owned by private equity
Ryanair	4.32	3%	19%	Slams the Dublin Airport Authority for again hiking fees
Air Berlin	2.33	-3%	-33%	Struggling tour operator Thomas Cook said to be shopping its German airline unit Condor
Norwegian	80.50	0%	-35%	Renews bulk air service contract with Norway's military
Vueling	5.28	1%	-54%	Spanish airports saw a 3% y/y decline in traffic last month, according to AENA
Aegean	1.37	2%	-39%	Badly struggling rival Cyprus Airways shrank ASK capacity by 23% last year (*anna.aero*)
Japan Airlines	(not publicly traded)			Will retire its last MD-90s in the upcoming fiscal year
All Nippon	251	6%	-19%	Narita: 220k available slots per year to 300k by 2015; daytime int'l slots at Haneda to double
Korean Air	58100	2%	-18%	Seoul's Incheon airport handled 35m passengers in 2011, up 5% from 2010
Cathay Pacific	15.94	1%	-19%	New prem. econ. seats now on sale; launch markets: Sydney, Toronto, Vancouver, New York
Air China	6.26	-3%	-24%	Awards IT contract to SITA, which will handle its network communications globally
China Eastern	3.01	-2%	-19%	*China Post* indicates that Taiwan's EVA Air might order six B777s this year
China Southern	4.04	-2%	0%	January RPKs up 17%, but caution: benefited from January Chinese New Year this year
Singapore Airlines	6.59	2%	-19%	Selling some of its older B777s to Russia's Transaero
Malaysia Airlines	1.49	-6%	-29%	Scheduled to join oneworld in late 2012 following Air Berlin's entry; Kingfisher out for now
AirAsia	3.66	-3%	33%	AirAsia X, with its 11 planes, grew both Q4 ASK capacity and RPK traffic by 12% y/y
Thai Airways	26.00	-1%	-38%	Becomes the world's ninth A380 operator when it takes delivery of its first of six units in Q3
Cebu Pacific	74.50	1%	-17%	Air Phil Express, owned by Philippine Airlines, launching domestic hub at Manila Clark
Qantas	1.64	4%	-35%	Saw corporate revenue grow 12% y/y in the half despite labor unrest
Virgin Australia	0.35	0%	-13%	Will report July-to-December financial results Thursday
Air New Zealand	0.69	-4%	-34%	Will report July-to-December financial results Friday

Some stocks traded on multiple exchanges; not intended for trading purposes

The Southwest Defect: Long-time low-cost leader deals with unfamiliar challenges

CONTINUED FROM p. 6

Atlanta, it might choose to do so—paying online travel agency commissions and allowing customers to easily compare its fares to competitors in Albuquerque would make little sense, whereas in Atlanta—where advertising is also more expensive—it might be a relatively efficient way to acquire customers. Alas, it would be nearly impossible to distribute so differently in different U.S. cities, so Southwest will have to attack Atlanta, like Philadelphia before it, with a distribution strategy that's suboptimal for that market.

And one thing is nearly certain: either Southwest will ultimately shrink its total presence (including current AirTran service) in Atlanta considerably, or it will lose a lot of money there. That's because the airline plans to "de-bank" AirTran's hub and rely more on local passengers than the connecting passengers that filled the majority of AirTran's flights at Atlanta. It's a worthy goal: local passengers pay more, and again, higher-cost Southwest needs higher fares than AirTran needed. But local demand, especially in a market like Atlanta with limited inbound tourism, is finite. The main way to increase the percentage of local traffic is to decrease capacity. The lack of inbound leisure demand is one reason, by the way, why Southwest's plan to use its rather successful experience in Denver as a template for Atlanta might be more difficult than it envisions.

These are just a few of the tough choices now facing Southwest, which—don't forget—is by many standards the most successful airline in the history of the world.

Southwest has gone through three phases over the past few decades: 1) the 1990s, when it was the only significant low-cost carrier in a cheap-fuel environment and thus enjoyed an enormous cost advantage over everyone; 2), the 2000s, when other LCCs emerged and fuel grew expensive, but Southwest paid far less for it than everyone else thanks to hedges, and thus enjoyed an enormous cost advantage over everyone; and 3) now, when it is competing on the most level playing field ever.

Southwest is in its own way "caught in the middle." No, it's certainly not facing existential challenges like the ones confronting other airlines, like mid-sized European legacy carriers, about whom that term is often used. It is, however, caught between newly lean and mean U.S. legacy carriers, whose costs are now only modestly higher than Southwest's and whose revenue opportunities are significantly higher, and lower-cost carriers with the same kinds of advantages over Southwest that Southwest once had over everyone else. Accordingly, carriers like United and Delta on one hand, and Spirit and Allegiant on the other, are generating higher profit margins than Southwest.

As unfair as it might seem, some of Southwest's historical assets have now become liabilities. Yes its employees generally earn more than those at any other airline, but at least they work hard and are a part of what's generally been one of the better corporate cultures in all of America, let alone the airline industry. But maintaining the *esprit de corps* means furloughs and pay concessions that are so common at other airlines aren't even a consideration at Southwest. In turn, the only way to keep costs in check is to keep growing—hiring new employees, who bring average labor rates down, and generally spreading fixed costs among more production—but alas, Southwest isn't growing anymore: it's hard to turn profits in marginal new markets with $100 oil. And so its unit costs are rising faster than those at almost any other airline.

But don't accuse Southwest of standing idly by. Last year it revamped its frequent flier plan, generating an incredible $250m annual increase in partner mileage sales. It ordered B737-800s—the first of which will arrive next month—and B737-MAXs. These larger and more efficient planes should hold down unit costs, as should a less sexy but likewise important initiative to add a row of seats to its existing B737-700s. Sometime this year it plans to choose a new reservation system (a task that's more difficult for it than for most airlines—off-the-shelf technology isn't designed to handle such a unique airline with its 700 airplanes and several dozen focus cities, where passengers connect). And most significantly, it bought and is now integrating AirTran.

The good news is that the AirTran acquisition yielded some important immediate and near-immediate synergies. On the revenue side, Southwest could suddenly raise fares because it now owned rather than competed against AirTran—especially in cities like Baltimore, Orlando and Milwaukee, where the two had battled fiercely, as well as in numerous connecting markets. On the cost side, certain airport functions, among other things, were quickly merged. The question now is whether those synergies are just the beginning, or whether Southwest faces declining returns going forward. That's a legitimate concern because while Southwest happily got its major work groups to quickly agree on integration issues—something that can often take years—that also means it will be stuck giving big raises (totaling $150m annually) to a lot of people before it gets some of the revenue it needs to offset those costs. Of particular concern is the fact that because of technical deficiencies, Southwest and AirTran can't even codeshare with each other yet. Hundreds of AirTran flights full of passengers in Atlanta, in other words, can't feed the new Southwest flights—as if Southwest's other challenges there weren't formidable enough.

That issue highlights why merging two ostensibly "simple" low-cost airlines is, counter-intuitively, perhaps more complex than merging two legacy carriers: United and Continental, for example, were already well aware of how to organize a codeshare before they merged. And it's an issue that will likely be a significant drag on 2012 earnings. But the good news is that Southwest will surely figure that out sooner or later.

Of bigger concern going forward is whether Southwest's historical strengths will be enough for it to navigate a very new world, one in which it will often be not just the hunter but the hunted, playing not just offense but also defense: while it's busy retreating from its attack on Philadelphia, Spirit is assaulting Las Vegas and now Denver, among other Southwest strongholds. Airlines like Spirit, by the way, have the flexibility to enter markets with infrequent service because they outsource ground handling. That, by the way, is something AirTran has always done and Southwest won't adopt—a negative synergy of the merger, because Southwest has to exit some infrequent but profitable AirTran markets only because that kind of flying (as little as a few times a week, a la Ryanair, rather than many times a day) is just not what Southwest does. Or consider that Southwest might take solace in knowing that it still does tend to have a cost advantage over competitors in the shortest-haul markets (which once made up most of its network), but those are the very markets where airport security hassles have pushed travelers out of the air and into trains and cars.

Put another way, being the best at certain things might not be enough when the world changes and those things don't matter as much. Or even more bluntly: Kodak makes the best film.

Southwest, though, won't likely go the way of Kodak. It still has billions in the bank with little debt, and it still produces solid profits, albeit no longer industry-leading ones. One challenge now might be to rediscover the entrepreneurial spirit that served it so well in its early days. Yes, that can be difficult for a company that's now huge, but on the other hand its size and financial strength make risk-taking, well, less risky than it would be for most. Many of its low-cost disciples around the world, from Ryanair to AirAsia to WestJet, now regularly outperform Southwest. Maybe now it's Southwest's turn to learn a few things from them—and even from the legacy airlines that now outperform it. ❍