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Southwest Airlines Co.—2004

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Despite terrorist attacks, new security measures, dramatic increases in aviation insurance costs, industry downsizing, rising energy costs, and a severe reduction in consumer air travel, Southwest Airlines is still poised for success. For twelve consecutive years (1991 through 2002), the Department of Transportation (DOT) Air Travel Consumer Report listed Southwest Airlines (tel. 214-792-4000 or 1-800-I-FLY-SWA) as among the top five of all major carriers for on-time performance, best baggage handling, and fewest customer complaints. In a highly competitive industry, all carriers continually strive to place first in any of these categories of the DOT report; Southwest is the only airline to ever hold the Triple Crown (first in all of the categories) for its annual performance. In addition to this honor, Southwest is consistently among *Fortune* magazine's most admired companies (second in 2002), and it is also on the magazine's list of the 100 best companies to work for.

In 2002, Southwest ranked first among airlines for customer service satisfaction, as reported in the *Wall Street Journal.* In addition, Southwest ranked first in *Money Magazine*'s feature for "The 30 Best Stocks" since 1972. Southwest continues to operate profitably despite geopolitical tensions: In 2003, it had \$442.0 million in net income on \$5.8 billion in revenues (Southwest *Annual Report,* 2003).

In an industry that historically has been awash in red ink, where airlines continually go in and out of bankruptcy or fail, Southwest has an enviable record of over thirty consecutive years of operating at a profit. But, considering the tremendous strain in current economical and political environments, can this record of success continue?

In their best-selling book *Nuts,* Kevin and Jackie Freiburg point to a company with people who are committed to working hard and having fun and who avoid following industry trends. The Freiburgs note that Southwest, based in Dallas, Texas, is a company that likes to keep prices at rock bottom; believes the customer comes second; runs recruiting ads that say, "Work at a place where wearing pants is optional"; paints its \$30 million assets to look like killer whales and state flags; avoids trendy management programs; avoids formal, documented strategic planning; spends more time at planning parties than writing policies; and once settled a legal dispute by arm wrestling. This strategy has always worked, but will it continue to work?

History and Growth of Southwest Airlines

Rollin King and Herb Kelleher completed the necessary paperwork to create Air Southwest Co. (later renamed Southwest Airlines). Then the two filed for approval with the FAA; and on February 20, 1968, the Texas Aeronautical Commission approved their plans to fly between the three cities.

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In the 1980s and 1990s, Southwest continued to expand, and by 1993, it was serving 34 cities in 15 states. Southwest slowly, but methodically, moved across the Southwestern states into California, the Midwest, and the Northwest. It added new destinations in Florida and on the East Coast. With its low prices and no-frills approach, it quickly dominated the markets it entered. In some markets, after Southwest entered, competitors soon withdrew, allowing the airline to expand even faster than projected. For example, when Southwest entered the California market in 1990, it quickly became the second-largest player, with over 20 percent of the intrastate market. Several competitors soon abandoned the Los Angeles–San Francisco route because they were unable to match Southwest's $59 one-way fare. Before Southwest entered this market, fares had been as high as $186 one way.

California offers a good example of the real dilemma facing competing carriers, which often referred to Southwest as a "500-pound cockroach that was too big to stamp out." While airfares were dropping, passenger traffic increased dramatically. But competitors, such as American and US Airways, were losing money on several key route segments, even though they cut service drastically. In late 1994, United began to fight back by launching a low-cost, high-frequency shuttle service on the West Coast. But it found that even a shuttle could not win against Southwest in a head-to-head battle. So United repositioned its shuttle away from Southwest's routes and even abandoned some routes altogether. According to the DOT, eight airlines surrendered West Coast routes to Southwest; at the same time, one-way fares fell by over 30 percent to an average of $60, and traffic increased by almost 60 percent. The major problem for the larger airlines was the fact that many of these West Coast routes were critical for feeding traffic into their highly profitable transcontinental and transpacific routes, and Southwest was cutting into that market.

Southwest is currently the fourth-largest domestic carrier in terms of customers boarded. The airline has transformed itself from a regional carrier operating out of Dallas into a truly national carrier. At year-end 2002, the airline served 58 cities in 30 states and operated more than 2,800 flights a day with its fleet of 375 Boeing 737s. In 2002, Southwest flew 45.4 billion revenue passenger miles (RPMs) compared with 44.5 billion RPMs in 2001. But most remarkable is its thirtieth year in a row of profitable operations, with total operating revenue in 2002 of $5.52 billion—a decrease of 0.6 percent over 2001. Operating income in 2002 fell by 33.9 percent in 2001. Net income fell by 52.9 percent from $511.1 million in 2001 to $241.0 million in 2002 (Southwest *Annual Report*, 2003). Nonetheless, Southwest was the only profitable major U.S. airline in 2002. Financial statements are shown in Exhibits 1 and 2.

Management

Lamar Muse led Southwest in its climb to profitability; but, in a dispute with the board, he was ousted in 1978. With Muse out, Kelleher moved into the top position, and ran the airline until June 19, 2001. On that date, Kelleher was succeeded as CEO by Southwest's vice president and general counsel, James F. Parker, 54. Colleen C. Barrett, 56, who started her collaboration with Mr. Kelleher thirty-four years earlier as his legal secretary, would be president and chief operating officer. Mr. Kelleher is slated to remain as chairman for three years. Exhibit 3 shows the organizational chart of the company.

Mr. Parker has been the airline's top labor negotiator, making him well known to the company's employees, and, according to Mr. Kelleher, he has had a say in every important decision for a "long, long time." Ms. Barrett, the unsung hero of Southwest, has been the keeper and crusader of Southwest's culture, and she has successfully indoctrinated thousands of new workers into Southwest's ways. Parker's plan as CEO is to stay with the blueprint—keep Southwest the low-cost, low-fare, no-frills airline it

EXHIBIT 1

Operating Statistics for Southwest Airlines

CONSOLIDATED HIGHLIGHTS			
(in thousands except per-share amounts)	*2002*	*2001*	*Change*
Operating revenues	$5,521,771	$5,555,174	(0.6)%
Operating expenses	$5,104,433	$4,924,052	3.7%
Operating income	$417,338	$631,122	(33.9)%
Operating margin	7.6%	11.4%	(3.8)pts.
Net income	$240,969	$511,147	(52.9)%
Net margin	4.4%	9.2%	(4.8)pts.
Net income per share—basic	$0.31	$0.67	(53.7)%
Net income per share—diluted	$0.30	$0.63	(52.4)%
Stockholders' equity	$4,421,617	$4,014,053	10.2%
Return on average stockholders' equity	5.7%	13.7%	(8.0)pts.
Stockholders' equity per common share outstanding	$5.69	$5.24	8.6%
Revenue passengers carried	63,045,988	64,446,773	(2.2)%
Revenue passenger miles (RPMs) (000s)	45,391,903	44,493,916	2.0%
Available seat miles (ASMs) (000s)	68,886,546	65,295,290	5.5%
Passenger load factor	65.9%	68.1%	(2.2)pts.
Passenger revenue yield per RPM	11.77¢	12.09¢	(2.6)%
Operating revenue yield per ASM	8.02¢	8.51¢	(5.8)%
Operating expenses per ASM	7.41¢	7.54¢	(1.7)%
Employees at year-end	33,705	31,580	6.7%

has always been. "There will be no change in our core philosophy and our basic business model," he says. It's a model he helped shape as general counsel for fifteen years.

Southwest's management team drives home the feeling that all of its people are part of one big family. Southwest's Culture Committee, formerly headed by Colleen Barrett, has unique ways to preserve the company's underdog background and can-do spirit. She constantly reinforces the message that employees should be treated like customers, and continually celebrates workers who go above and beyond the call of duty. Barrett also regularly visits each of the company's stations to reiterate the airline's history and to motivate employees. As keeper of the company's culture, Barrett commemorates all employee birthdays and special events with cards signed, "Herb and Colleen." Employees know the culture and expect others to live up to it. Donna Conover, another longtime Southwest employee who also understands and supports the company's culture, will succeed Barrett as president and COO.

Strategy

Southwest's operation under Herb Kelleher has a number of characteristics that seem to contribute to its success. It has always been able to quickly seize a strategic opportunity whenever one arises. Other key factors are its conservative growth pattern, its cost-containment policy, and the commitment of its employees.

Kelleher always resisted attempts to expand too rapidly. His philosophy was to expand only when there were resources available to go into a new location with ten to twelve flights per day—not just one or two. For years, he also resisted the temptation to begin transcontinental operations or to get into a head-to-head battle with the

Competitors believe that Southwest would have moved strongly into the long-haul flights market despite the altered tax requirements. "They've dug all the shallow holes," says Rona J. Dutta, senior vice president for planning at United Airlines, Inc. He also replies that other low-fare units are increasing the competition in Southwest's core markets. As all other major airlines have performed poorly since the 2001 terrorist attacks, many are expanding or developing low-fare flight programs in an effort to increase profits. Short-haul lines such as JetBlue, Spirit, ATA, AirTran, SkyWest, and Frontier Airlines, as well as Delta's Song and Continental's JetExpress, may be affecting Southwest's profitability, but with its lower costs and impressive balance sheet, Southwest still prevails. Nonetheless, some low-fare lines have ended operations because they were unsuccessful in competing with existing low-fare lines. These include US Airways' MetroJet, Shuttle by United, Vanguard, and National airlines.

Southwest continues to be the lowest-cost airline in its markets. Even when trying to match Southwest's cut-rate fares, the larger carriers could not do so without incurring substantial losses. Southwest continues to operate with the lowest cost-per-available-seat mile (the number of seats multiplied by the distance flown) among all major airlines, with an average of 15 to 25 percent below its rivals. One of the major factors in this enviable record is that all of its planes used to be of a single type—Boeing 737s—which dramatically lowered the company's cost of training, maintenance, and inventory. Because all Southwest crews know the 737 inside and out, they could substitute personnel rapidly from one flight to another in an emergency. In addition, Southwest recognized that planes only earn you money while they are in the air, so the company worked hard to achieve a faster turnaround time on the ground. Most airlines take up to one hour to unload passengers, clean and service the plane, and board new passengers. Southwest has a turnaround time for most flights of twenty minutes or less. Thorough knowledge of the 737 has helped in this achievement.

Southwest has also cut costs in the customer service area as well. Because its flights are usually one hour or less, it does not offer meals—only peanuts and drinks. Boarding passes are reusable plastic cards, and boarding time is saved since the airline has no assigned seating. The airline does not subscribe to any centralized reservation service. It will not even transfer baggage to other carriers: That is the passenger's responsibility. Even with this frugality, passengers do not seem to object, since the price is right.

This ability to turn planes around rapidly, surprisingly, has not been jeopardized by the events after September 11, but this did not happen without incurring added expenses. Initially, new government-mandated security procedures did cause delays and longer check-in times. Since then, Southwest has added new automated systems and technologies that have streamlined the check-in process. This includes computer-generated baggage tags and boarding passes and self-service Rapid Check-in kiosks. Because of these additions, Southwest reports that check-in times are almost back to normal.

Southwest has achieved a team spirit that others can only envy. One of the reasons for this team spirit is that the company truly believes that employees come first, not the customers. Southwest is known for providing its employees with tremendous amounts of information that will enable them to better understand the company, its mission, its customers, and its competition. Southwest believes that information is power. It is the resource that enables employees to do their jobs better. Armed with this knowledge, they are able to serve the customer better, and customers who deal with Southwest rarely get the runaround.

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Even though unionized, Southwest has been able to negotiate flexible work rules that enabled it to meet the rapid turnaround schedules. It's not unusual for pilots to help flight attendants clean the airplanes or to help the ground crew load baggage. Consequently, employee productivity is very high, and the airline is able to maintain a lean staff. In good times, Kelleher resisted the temptation to overhire, and so avoided layoffs during lean times. Southwest has only laid off three people in twenty-five years—and it immediately hired them back. The airline industry as a whole has furloughed approximately 100,000 employees as a result of the 2001 attacks. Not only did Southwest lay off no one, it also hired employees in 2002 and increased overall salaries, wages, and benefits. This was made possible by reductions in other areas: New plane deliveries were delayed, renovations to the company headquarters were scrapped—but layoffs were not considered. Said CEO Parker, "We are willing to suffer some damage, even to our stock price, to protect the jobs of our people." This employee retention policy has contributed to employees' feelings of security and a fierce sense of loyalty. The people of Southwest see themselves as crusaders whose mission is to give ordinary people the opportunity to fly.

Maximizing profitability is a major goal at Southwest. This leads to a drive to keep costs low and quality high. The airline's ideal service consists of safe, frequent, low-cost flights that get passengers to their destinations on time—and often closer to their destination than the major airlines do, because its competitors use larger airports farther from the cities. Southwest uses Dallas's Love Field, Houston's Hobby Airport, and Chicago's Midway, which are closer to their respective downtown areas, are less congested, and are, therefore, more convenient for the business traveler. This also helps Southwest's on-time performance.

In its marketing approach, Southwest always tries to set itself apart from the rest of the industry. It also plays up its fun-loving, rebel reputation. In the early years, when the big airlines were trying to run Southwest out of business by undercutting its low fares, Southwest made its customers an unprecedented offer. In response to a Braniff ad offering a $13 fare to fly between Houston and Dallas, Southwest placed an ad that read, "Nobody's going to shoot Southwest Airlines out of the sky for a lousy $13." It then offered passengers the opportunity to purchase a ticket from Southwest for the same price, which was half the normal fare, or to buy a full-fare ticket for $26 and receive a bottle of premium whiskey along with it. The response was unprecedented. Southwest's planes were full and, for a short time, Southwest was one of the top liquor distributors in the state of Texas.

Southwest's ads always try to convince the customer that what the airline offers them is of real value to them. It also believes it is in the business of making flying fun. With its ads, the company wants customers to know that when they fly Southwest, they'll have an experience unlike any other. It promises safe, reliable, frequent, low-cost air transportation that is topped off with outstanding service. By keeping its promises, Southwest has earned extremely high credibility in every market it serves.

e-Business

Southwest has been aggressively marketing its services on the Internet, and it was the first airline to establish a home page on the Web. When *Fortune* magazine asked the experts which businesses have Web sites that work, the answer they got was "not many." However, Southwest was one of ten cited as a business doing it right. In the Internet travel race, many observers think Southwest has lost the battle to a subsidiary of American Airlines, Travelocity. Yet while American has been getting most of the attention, Southwest has been getting the business. According to a Nielsen/NetRatings' survey, 13.8 percent of the people who visited Southwest's site booked a flight. The company's "look-to-book" ratio is twice that of Travelocity and higher than that of any traditional retailer on the Web. Southwest, it seems, has been a success in turning browsers into buyers. In March 2002, *InternetWeek* reported that Southwest experienced an Internet traffic gain of 16 percent. Southwest reports that approximately 50 percent of its passenger revenue is generated by online bookings. Its cost-per-booking via the Internet is about $1; in comparison, the cost-per-booking via a travel agent is about $10.

Southwest's Web site has also been named the top-ranking Web site for customer satisfaction among major travel sites, according to research conducted by Harris Interactive. The Southwest site scored a rating of 8.62 out of 10, with its Web site attracting 4 million unique visitors during March 2001. In the June 11, 2001, issue of *InternetWeek,* Southwest's Web site was named as one of the top 100 e-businesses in the United States, as determined by the publication's survey.

Competitors

Since September 11, 2001, competition for Southwest Airlines has shifted from major airlines to low-fare airlines. This happened mainly because major airlines incurred losses in 2002. Before September 11, 2001, United, the second-largest airline with over 100,000 employees, was one of Southwest's most formidable competitors. Since then, the company has downsized to approximately 85,000 employees. Because of financial losses, United filed for bankruptcy in December 2002. Since United Shuttle service ceased operations shortly after September 11, 2001, direct competition with Southwest Airlines has diminished.

Following September 11, 2001, Delta, the third-largest U.S. carrier, cut 21 percent of its workforce and in 2003 was operating with approximately 75,000 employees. Delta flies to about 225 U.S. and foreign locations, and remains particularly strong throughout much of the southern tier of the United States, where two of its major hubs—Atlanta and Dallas/Fort Worth—are located. In the summer of 2003, Delta replaced its low-fare regional carrier service Delta Express with Song, in an effort to better compete with low-fare airlines like Southwest. Delta has also acquired a minority stake in three regional airlines which can feed passengers into its several hubs, and has established an alliance with Continental and Northwest Airlines.

A third past competitor, America West, is faring better than both Delta and United. In July 2002, America West recalled virtually all employees furloughed after the September 11, 2001, attacks. Despite net income losses of $388 million in 2002, American West expects to restructure its finances with the help of federal loan guarantees totaling $380 million. It has about 11,000 employees and serves 144 cities in the United States with foreign locations in Mexico and Canada. America West has strong positions in its hubs, Phoenix and Las Vegas. These locations put it into direct competition with Southwest. With Continental and Mesa Airlines, which have small stakes in America West, America West has formed alliances which give it access to another thirty-five destinations.

The low-fare carriers are doing better because they don't rely on high business fares and don't offer the frills the major carriers offer. They tend to gravitate toward secondary airports where less congestion and lower fees keep costs down. Many also fly point-to-point without stops, and in general have relied on highly efficient e-business. Most importantly, low-fare airlines have succeeded in appealing to the customer in ways that major airlines never could by using creative market strategies and promoting individualism. As a result, customers are intrigued by this new mode of transport and after trying it, are convinced that it is the new way to travel. In 1994, revenues earned by low-fare carriers represented 5 percent of the $76 billion U.S. air travel market. By 2003, their share was over 20 percent, according to *CFO* magazine, up from just 10 percent in 2000. Experts predict that low-fare airlines will have 25 to 35 percent of the market share by the end of 2004, an increase that may restructure the airline industry forever.

JetBlue is one of Southwest's newest and possibly most noteworthy competitors. In 2002, JetBlue was the only other airline to report profits, with $55 million on revenues of $635 million. In 2003, despite geopolitical tensions, JetBlue was hiring an average of six new employees a day to accommodate growth. JetBlue's founder and CEO is David Neeleman, who was employed in the inner circle of Southwest for over a year. Thus it is no surprise that JetBlue is structured similarly to Southwest: a low-cost, low-fare airline with high employee productivity, a laid-back attitude, and a single aircraft model. Perhaps these are the reasons that JetBlue continues to grow and earn profits. It may also explain why Southwest's CFO Gary Kelly stated, "We've got to be prepared for intense competition." In fact, Southwest gave model JetBlue planes to its executives with a note: "Know your enemy." Currently, the two airlines don't compete in many of the same markets, but being the only two airlines experiencing significant growth, they are certainly affecting each other's potential growth.

All of the competitors have come into head-to-head competition with Southwest on several occasions. Southwest always welcomed competition and firmly believes it can come out ahead in any of those situations. Kelleher, when asked about his thoughts on facing a competitor such as the United Shuttle head-on, stated, "I think its good to have some real competitive activity that gets your people stirred up and renews their vigor and their energy and their desire to win."

Long-haul success for Southwest will put pressure on the profits realized by its bigger competitors. The cost advantage for Southwest includes the rapid twenty-minute gate turnarounds; an efficient all-Boeing 737 fleet, including new 737-700s that can fly cross-country nonstop; and a more productive workforce. Even if longer flights increase the costs, Southwest still realizes a significant competitive advantage. Roberts, Roach & Associates Inc., an airline consultant in Hayward, California, says that Southwest has at least a 59 percent cost advantage over bigger rivals at flights of 500 miles, as well as a 35 percent lead for flights at 1,500 miles. "It's a huge threat," says a rival airline executive. Already, according to an estimate by analyst Samuel C. Buttrick from Paine Webber, Inc., nonstop flights longer than 1,000 miles account for more than 16 percent of Southwest's capacity. Southwest is not the only low-fare airline that has expanded long-haul services in recent years. According to a report from the Department of Transportation, AirTran Airways, ATA Airways, Frontier Airlines, JetBlue Airways, and Spirit Airlines, along with Southwest, have expanded long-haul services by 26 percent between 2000 and 2002. Will longer flights for these airlines also mean a loss in profits due to increased costs, or could low-fare airlines win an even larger portion of the market to reign in the American skies?

For now, considerations for serious expansion have been put on hold as many airlines are still trying to recover from losses over the past two years. Southwest will continue its strategy to capitalize conservatively and increase growth steadily. It is capitalizing on the schedule cutbacks other airlines have made, but as a result, the door is also open for other low-fare carriers to profit.

The Future

Today, Southwest provides service to only fifty-eight cities, so there are tremendous opportunities for expansion. The problem: Competitors have learned from Southwest and its unique management strategies, and they are using these tactics as well as unique ones to win over consumers. Southwest has always utilized conservative growth tactics, but this may hurt it if new competitors opt for faster growth strategies. Over 100 cities have asked Southwest to begin service in their communities because of the positive impact the company has had when it began operations in a new location. But if Southwest doesn't do it, another low-fare airline will.

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Develop a clear three-year strategic plan for Southwest.