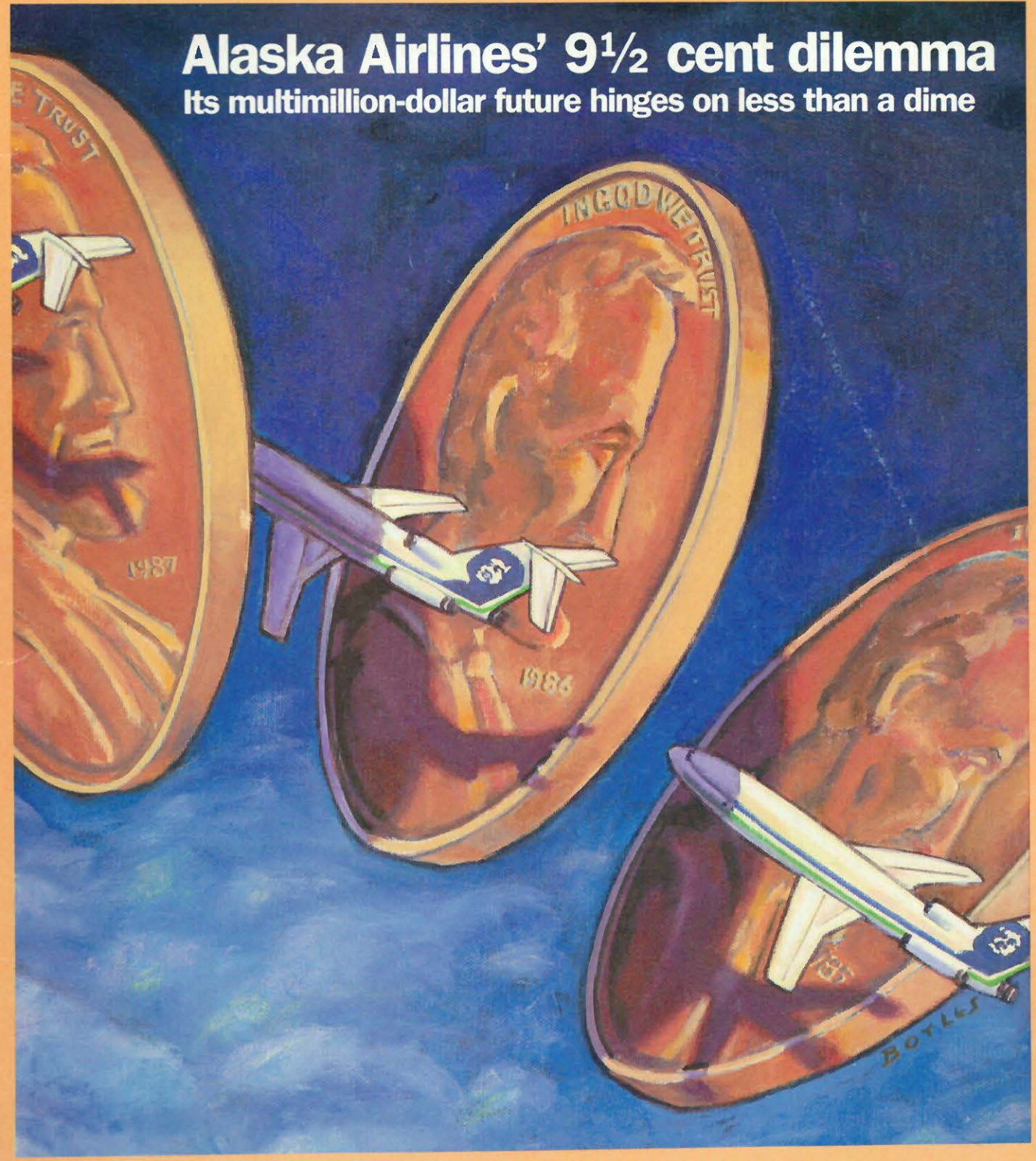


ALASKA BUSINESS Monthly

Alaska Airlines' 9½ cent dilemma
Its multimillion-dollar future hinges on less than a dime





Alaska Airlines encounters strong headwinds at 9½ cents

(Brother, it can't spare a dime)

BY PAUL LAIRD

THE FUTURE OF Alaska Airlines could depend on what happens over the next few months to a 9½-cent item sandwiched somewhere between \$433 million in revenues and \$537 million in assets on the airline's 1985 financial and operating statements.

Nine-and-one-half cents ... barely enough to qualify for the layaway plan on a cup of coffee. It's the amount Alaska Airlines spent on operating expenses for each seat-mile it flew last



year — occupied or vacant. It's also 1 to 3 cents more than most of its competitors spent for the same thing.

Now multiply 9½ cents by Alaska's 4.2 billion available seat miles in 1985. All of a sudden we're not talking pocket change anymore. We're talking about a multimillion-dollar issue that could spell the difference between profit and loss, between expansion and contraction, between survival and extinction.

"Two key issues will determine the future of Alaska Airlines — fare struc-

tures and costs," says William Whitlow, vice president in charge of research in the Seattle office of Dain Bosworth, a brokerage firm. "Alaska can't control how long the fare wars will last, and it has to cut its costs to be competitive on the West Coast."

Building on its reputation for above-average service, sound management and a planned approach to expansion, Alaska Airlines has grown from a major Alaskan carrier to a dominant regional carrier operating throughout the West Coast. With the addition of Tucson in September, it serves 30 destinations in seven western states — Alaska, Washington, Oregon, California, Arizona, Idaho and Nevada.

1986 likely will see little or no route expansion for Alaska, regardless of its success at cutting operating overhead. "The focus this year will be on scheduling and frequency," says Peter Musser, partner in Seattle's Cable, Howse & Ragen investment banking firm. "There probably will be no new routes south of Seattle."

Beyond 1986, however, this year's cost-control efforts will play a pivotal role in determining strategy and performance.

With significant cost reductions, the airline probably will continue what one analyst calls its "deseasonalization" effort to even out revenue valleys in the first and fourth quarters by adding new Sunbelt locations like Reno, Albuquerque and El Paso. In the longer term, Alaska is evaluating nonstop service between the East and West coasts.

Without reductions, the future is murky. Eventually the airline won't be able to compete with lower-cost carriers on the West Coast, and that could force it to redeploy some of its fleet from new routes in the Lower 48 to markets it already dominates north of Seattle — markets admittedly less prone to fare wars, but ones that also put severe limitations on the company's growth, its ability to service new debt from the recent purchase of nine new jets and its ability to pursue its goal of spreading fixed operating costs over a larger revenue base.

Says Alaska Chairman and CEO Bruce Kennedy, "If we can't make profits with what we have now, our directors certainly won't be inclined to buy more new planes or take on any new risks. The company just won't expand. Unfortunately, in this industry you can't shrink yourself into profitability."

Alaska Airlines has developed a track record of profitability that's unmatched in the U.S. airline industry. Earnings of \$25.9 million in 1985 marked its 13th consecutive year in the black. Net income has reached new highs each of the last five years.

But during 1985, earnings per share

also declined for the first time in five years. Last February the company sold 1.5 million shares of new stock to help pay for the purchase of the new jets. Nonetheless, its debt/equity ratio increased from 42 percent at the end of 1984 to 59 percent on Dec. 31, 1985.

Only a one-time \$5.3 million injection from the sale of a pair of Boeing 727 jets kept the company out of the red in the fourth quarter. Alaska actually sustained a \$4 million loss on operations during the three-month period.

The fourth quarter setback is attributed to a cutthroat West Coast fare war triggered Aug. 21 by Continental West when it began offering bargain-basement fares of less than \$70 between Los Angeles and Portland and Los Angeles and Seattle. One analyst describes it as "a game of chicken where you try to fill the plane but you can't make any money."

Dain Bosworth estimates Alaska generates nearly half of its revenues from flights south of Seattle, and Alaska was dragged into the fare-cutting fray along with other West Coast carriers. The alternative? Sacrifice market share and hope to win it back when fares returned to normal.

The fare war had negligible impact on Alaska's market share, but because of the lower fares, the yield per passenger mile plummeted nearly 20 percent, from 18.4 cents during the fourth quarter of 1984 to 15 cents in 1985's final stanza. Says J. Ray Vingo, vice president of finance at Alaska, "It just means we had to fly that many more passengers to generate the same revenues."

It's no surprise, then, that West Coast carriers breathed a collective sigh of relief Jan. 24 when Continental West announced it was dropping nonstop service between Los Angeles International and Seattle. The skirmish had left them bruised, but not incapacitated.

"The real question is whether the market being challenged can sustain more carriers," says RoseAnn Tortora, airline analyst for First Boston Corp. "Typically it's the new kids on the block who drop out if there's too much competition. But while the fare wars are going on, everyone is affected."

Analysts agree superior management and prudent expansion have positioned Alaska to weather short-term storms in its markets. Many carriers adopted a helter-skelter approach to route expansion and spread themselves too thin when federal regulatory shackles were removed in 1978, but Alaska methodically has extended its reach south from Seattle, focusing on less competitive markets like San Jose and Ontario before tackling giants like Los Angeles and San Francisco.

Although the Continental West episode demonstrates Alaska Airlines'

fourth outside Alaska, its impact on fourth quarter earnings also dramatizes Alaska's longer-term vulnerability. Fare wars and discounting have become the rule rather than the exception in the era of deregulation, and with its current cost structure, Alaska isn't as well positioned as its competitors to hold up under long-term pressure on its fares.

Since the strike-ridden second quarter, when Alaska won concessions from its ground crew workers and mechanics, operating costs have ebbed. Operating cost per available seat mile declined 2 percent from the same period the previous year in the third quarter and 7 percent in the fourth. Strike-related expenses pushed 1985's 12-month average 2 percent beyond 1984's.

But during the third quarter, Alaska's 9 cents in operating expenses per available seat mile still outpaced United Airlines by 20 percent, Western by 30 percent and Northwest by 38 percent. The 9 cents break down like this:

- Wages, salaries and benefits, 2.7 cents;
- Fuel, 2.2 cents;
- Maintenance, 0.4 of a cent;
- Aircraft rental, 0.4 of a cent;
- Travel agent commissions, 0.8 of a cent;
- In-flight food, 0.5 of a cent;
- Other, 1.9 cents.

"Other than labor costs, there isn't a lot that can be controlled," says Dain Bosworth's Whitlow. "You can buy a more efficient fleet, and Alaska's doing that with the new MD-83s. You can cut back on food service, but only a little since the hallmark of Alaska's reputation is service that's a cut above everyone else's. And you can cut back on things like advertising. But there isn't much you can do about fuel costs, maintenance, fleet rental and commissions."

Because of declines in world oil prices, fuel costs declined about 10 percent during 1985, Kennedy says. For each 1-cent drop in the price of aviation fuel, Alaska saves \$1 million on an annual basis. Fuel savings from price declines, however, do little to improve Alaska's bottom line and nothing to enhance its profitability. Those savings are shared by the airline's competitors as well, and in a highly competitive environment, they're passed through to consumers instead of being retained as earnings.

Despite the dependence of the airline's key market—the State of Alaska—on the health of the oil industry, the Alaska Airlines CEO says the net effect of declining oil prices on his company is positive. Says Kennedy, "We're so dominant in Alaska that we don't anticipate any declines there."

He adds route expansion in recent years has enabled Alaska to spread fixed costs over a broader base. Portland has surpassed Anchorage as the

airline's second largest hub behind Seattle. "And our 20 percent growth the last five years has created a lot of jobs." Alaska has about 3,300 employees, says company spokesman Lou Cancelmi.

In addition to the nine McDonnell Douglas-83s ordered in 1985—the last

727-200s. Savings come both from fuel efficiency and from trimming pilot crews from three to two. At the same time, Alaska is stressing savings from fuel conservation to its pilots, Kennedy says.

The airline is studying cutbacks on "services we provide that really don't matter that much to our customers," and it saved more than \$25,000 on its 1985 annual report by printing it on thinner stock and largely in black and white, he adds.

"We're looking to cut back on what we spend in 1986," says Kennedy. "We're cutting our advertising and working on establishing our identity in markets we already serve. We'll focus on our on-time record and service. But things happen quickly in this business. If we'd talked last year at this time, I wouldn't have been able to tell you we'd expand as much as we did in 1985. Long-term planning in the airline business is sort of a myth."

Focal points of Alaska's cost reduction program are wages, benefits and work rules. But in recent months a hiring freeze has been implemented. Layoffs are a possibility, says Alaska's chief executive, and the work force is being whittled through attrition.

About 80 percent of Alaska's work force is unionized. Earlier this year, members of the Air Line Pilots Association accepted a 15 percent salary cut through April 30, when their contract is open for revision. "But we feel strongly that we need a 26 percent reduction to be competitive," Kennedy asserts.









The airline wants a "B" pay scale that enables the company to pay new pilots less than veteran pilots. Senior pilots are paid about \$65,000 a year at Western Airlines, and Dain Bosworth's Whitlow says one potential competitor in Sun Belt markets pays \$50,000 a year for the same position. At Alaska, however, a senior pilot is paid \$100,000 a year.

Alaska wants concessions from its other three unions as well—including ground crew workers and machinists who struck the airline in 1985 before agreeing to a B scale. In exchange, Alaska is promising greater job security and a profit sharing plan that's based on pre-tax margins.

Talks with the Clerical, Office and Passenger Service union, which represents about 1,000 of Alaska's 3,000 employees, reached an impasse earlier this year and were scheduled for mediation. Alaska wants a B scale for future employees covered by that contract, too. Flight attendants already have a B scale, and their contract with the airline won't expire for two years.

While positioning to be more competitive in cutthroat West Coast markets, Alaska Airlines also is bracing for new competition between the Lower 48

How Alaska's Operating Costs Per Available Seat Mile Stack Up Against Competitors (Based on 3rd quarter 1985 results.)

	Air Cal	9.6
	Alaska	9.0
	PSA	8.5*
	United	7.5
	Western	6.9
	Northwest	6.5
	Continental**	6.2
	America West***	6.2

* Higher than normal in 3rd quarter because of late delivery of new planes

** Parent of Continental West

*** Viewed by analysts as a likely Sunbelt competitor

MarkAir data unavailable because of private ownership and variable cargo-passenger configurations of planes

three of which are scheduled for delivery in May—Alaska holds an option to buy three more. That option is due to expire in 1987, and Kennedy says Alaska may seek a one-year extension.

The new quiet-generation McDonnell Douglas jets enable Alaska to serve Southern California airports that have stringent noise restrictions. Dain Bosworth says the new jets also offer 20 percent operating savings over Boeing

and Alaska. AirCal, despite delays from its initial timetable of initiating Seattle-Anchorage service on March 1, still reportedly is planning to fly to Alaska.

Pacific Southwest Airlines (PSA) also is said to be investigating the Seattle-Anchorage route. One source, however, says both AirCal and PSA have become less and less enthusiastic about service between Alaska and the Lower 48 "as they've found out more about what it costs to operate here."

An Eastern Airlines insider says Eastern was negotiating for labor concessions earlier this year as a prelude to Anchorage service. An Eastern plan to be in Anchorage by Thanksgiving 1985

A snapshot of Alaska Airlines operations

	84-I	84-II	84-III	84-IV	85-I	85-II	85-III	85-IV
Passenger Load Factor (%)	45.2	52.8	58.4	51.5	49.7	59.1	57.3	50.9
Breakeven Load Factor (%)	48.2	45.9	47.8	45.5	49.4	50.8	49.0	56.8
Operating Cost/Available seat mile (¢)	8.9	9.1	9.2	9.9	10.5	9.8	9.0	9.2
Yield per Revenue Passenger Mile (¢)	16.7	17.0	16.3	18.4	18.4	16.8	15.9	15.0

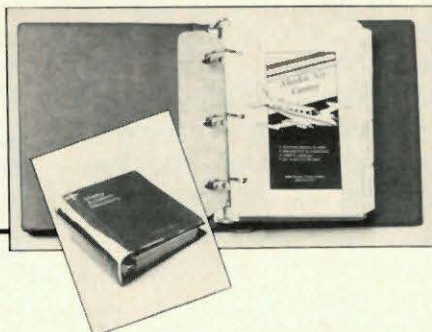


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fell through when the airline failed to secure concessions. Talks were resumed earlier this year.

AirCal, the only Alaska competitor with higher operating costs per available seat mile, doesn't have a reputation for bargain basement fare promotions like Continental West, analysts say, and it's unlikely to have a major impact on Alaska north of Seattle.

"AirCal is more likely to take market share from Western, Northwest and United, in that order," says Cable, Howse & Ragen's Musser. "AirCal doesn't have much feed to or from Seattle, and the frequency of service is likely to be limited." The other three airlines' feeds to and from Anchorage are limited as well, and that makes them more vulnerable to competition on the Seattle-Anchorage route.

Kennedy, however, says he expects AirCal "to come in and lower the fares. We'll both get bloody, and they won't last a year."

Expansion in the Lower 48 is done with Alaskan feeds in mind, and Alaska Airlines remains the dominant carrier within the state. "There's really only one expansion strategy, and that's to maintain and increase market share in Alaska and between Alaska and Seattle by adding routes that generate more feeds to and from Alaska," asserts one analyst. Alaskans are said to fly 13 times more than their Lower 48 counterparts, and that makes them a lucrative source of revenue.

Alaska Airlines also has an interchange agreement with American Airlines for service between Anchorage and Seattle/Portland and between Seattle/Portland and Chicago, Washington D.C., Dallas/Fort Worth and Houston. The benefit to each carrier is additional feeder revenues to and from those hubs. In an interchange relationship, compatibility of equipment enables pilots of either airline to fly the other company's planes on routes included in the agreement.

Analysts say less competition north of Seattle and within Alaska enables more stable pricing than south of Seat-

tle, but costs in Alaska are higher as well. A comparison of Alaska's per-available-seat-mile operating costs to intrastate carrier MarkAir's wasn't available. A MarkAir spokesperson said those data aren't tracked because of varying cargo and passenger configurations on MarkAir's Boeing 737 jets.

Alaska Airlines has made extensive use of interline agreements with six intrastate carriers to provide spoke service from its hubs to 62 communities throughout the state. They've generated feeds to and from communities too small to be served by Alaska's jets. The airline provides jet service to Anchorage, Fairbanks, Juneau, Ketchikan, Bethel, Prudhoe Bay, Nome, Kotzebue, Cordova, Yakutat, Glacier Bay (Gustavus), Petersburg, Sitka and Wrangell.

During 1985, Alaska ended its interline agreement with Airpac for service to Kodiak, Dillingham and King Salmon and switched to an agreement with intrastate rival MarkAir. While cooperating to assure through service to and from those markets, the two go head-to-head between Anchorage and Bethel, Fairbanks and Prudhoe Bay. Some observers suggest Bethel won't be able to support two jet carriers on a profitable year-round basis.

OTHER ALASKA INTERLINE carriers compete with MarkAir in Barrow and Dutch Harbor. Other commuter airlines with interline agreements are Bering Air in northern Alaska, Airpac in Dutch Harbor, LAB Flying Service in Southeast, ERA in Southcentral and Ryan Air in Interior and Northwest Alaska.

"On one hand we work closely with MarkAir to assure through service, and on the other hand they're fierce competition," says William MacKay, regional vice president for Alaska Airlines in Anchorage. "We deal with them as a subcontractor, and that's it. It's the only way we can legally and morally approach it." He says Alaska had similar interlines with Wien Air Alaska before Wien withdrew from rural Alaska and eventually went out of business.

Larry Anderson, vice president of sales and marketing at MarkAir, says Alaska approached MarkAir about providing interline service because Airpac's F-27 prop-driven planes "weren't compatible with (Alaska Airlines') level of service, and they'd had some operational problems because of it." MarkAir flies Boeing 737 jets, and MacKay says those have greater capacity for cargo and more comfort for passengers than Airpac's F-27 props.

The interline has worked well for both Alaska and MarkAir, the two carriers report, and at least temporarily it saves Alaska the expense of setting up shop in a new community. "We've never been able to open up a new market in

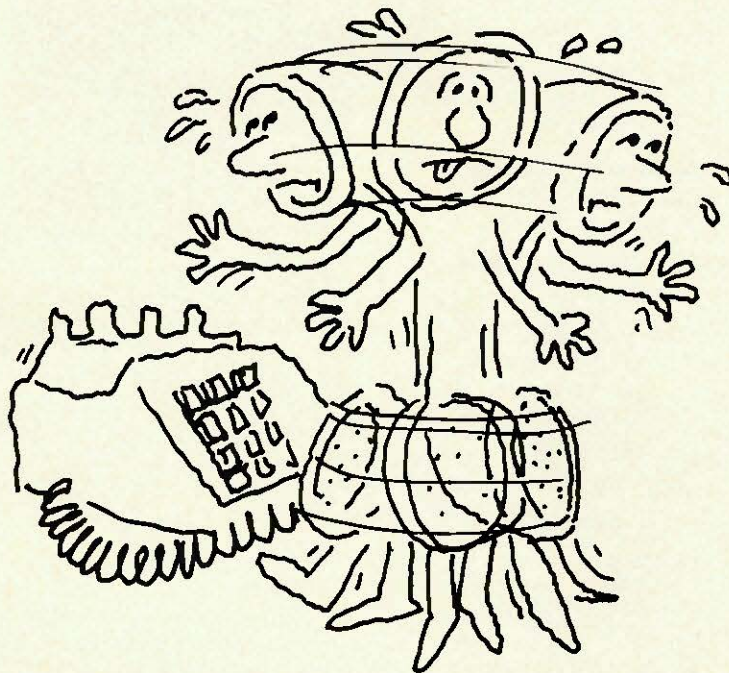
About that name...

WILL ALASKA AIRLINES' emphasis on growth in Lower 48 markets mean a new name? Wien Air Alaska, you'll recall, tried to reposition itself for expansion outside the state by becoming Wien Airlines.

Put it this way: Did the Los Angeles Rams change their name to the "Anaheim" Rams? Did the New York Jets and Giants become the New Jersey Jets and Giants? Did they start

calling the Cleveland Cavaliers the Richfield Cavaliers?

"The name 'Alaska Airlines' makes us instant news anytime we enter a new market," explains Bruce Kennedy, chairman and CEO. "There is one obstacle we're working to overcome: Some people see the name Alaska Airlines and think to themselves, 'If I ever want to go to Alaska, I'll have to give them a try ...'"



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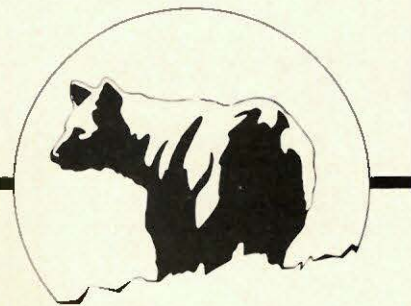
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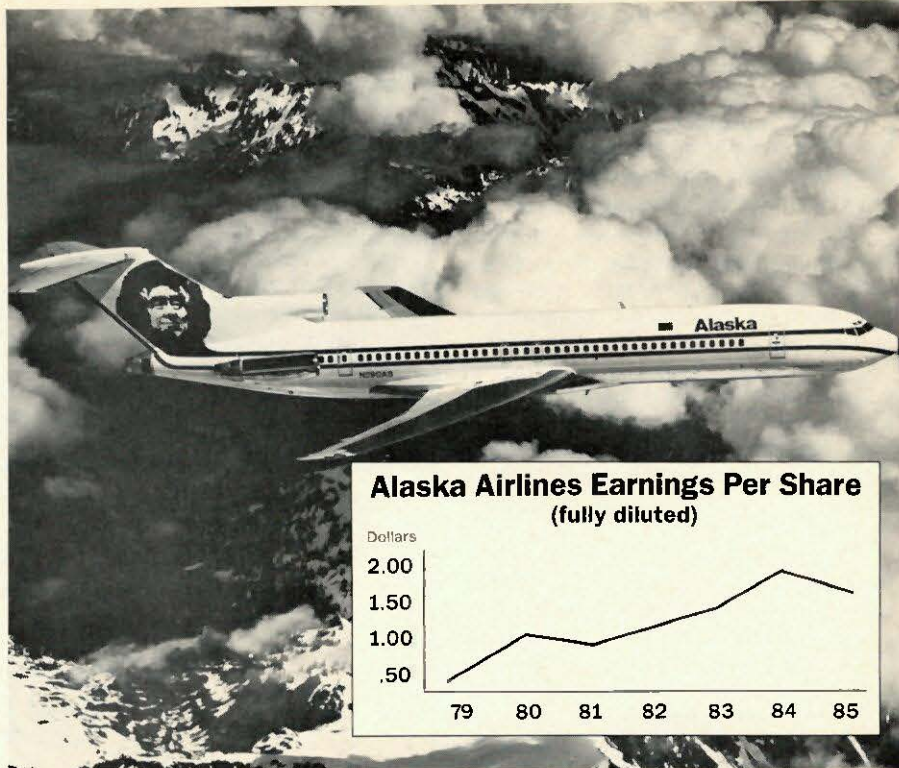
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A L A S K A



Alaska for less than \$1 million to \$1.5 million," says Alaska's regional vice president. "In Prudhoe Bay, the building cost us \$5-6 million."

While MarkAir would "look favorably" on extending the interline to other markets in the state, Anderson says, "we've never talked seriously about it. I guess when you start talking 'what if?' anything's possible."

Kennedy, however, says Alaska more likely will resume or initiate its own jet service to markets now served by interline agreements than convert additional markets to interline service. "If anything, we'll be going back to some of those markets," says the Alaska CEO. "Anything is fair game." Prime candidates, insiders say, are Kodiak and Barrow.

Cargo plays a bigger role in the airline's intrastate revenues; without mail subsidies for some Southeast communities and cargo to those communities and Nome and Kotzebue—particularly during winter months—the airline could be forced to rely on other carriers for those markets as well. There's speculation that as Southeast mail subsidies disappear, Alaska will make greater use of interline agreements to serve smaller Panhandle markets.

"We feel we have special expertise to provide the kind of service (the state) needs," says MacKay. "You have to have convertible equipment (planes that can be configured for large passenger or large cargo loads), and in that area we have an edge over anyone who would come into the market. There will probably be more changes in the Lower 48 because we've had less time for things to

evolve. Up here, we've made most of the logical adjustments."

South of Seattle, Alaska Airlines still has something to prove. To get the chance, it will have to weather ongoing pressure on its fares and sustain profitability. The downturn in profits has coincided with dramatic increases in the number of revenue passenger miles flown—they were up 35 percent in the fourth quarter and 25 percent for the year at Alaska. If there's a silver lining to fare wars, it's the fact that they stimulate more travel.

Productivity gains resulting from new contracts with flight attendants and mechanics in 1985 already are having a positive impact on operating costs, but Alaska Airlines says further cuts are mandatory if it's going to be competitive with West Coast competitors whose per-available-seat-mile costs are 15 to 30 percent lower. Each penny added more than \$1 million in operating costs with Alaska's fourth quarter capacity.

"The fourth quarter wasn't a disastrous situation for Alaska Airlines," says Dain Bosworth's Whitlow. "It's a well managed company, and until 1985 it had five years of growth in earnings per share. Labor concessions, however, hold the key to where they go from here."

Alaska Airlines officials clearly are determined to cut costs before the crisis stage is reached. Unless they succeed in trimming that misleadingly small 9½-cent line item this year, they may be forced to find out first-hand if it really is impossible to shrink an airline into profitability. □