

Strategic Report for Southwest Airlines

Pandora Group
Out of the Box Consulting

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Executive Summary

Southwest Airlines has been a strong growth company over the last 35 years. Using its low-cost, passenger friendly, point-to-point operational strategy, Southwest has been able to sustain considerable growth year after year and remain profitable for 33 straight years. Southwest Airlines now has a market capitalization of \$14 billion and is positioned as one of the strongest airlines in the struggling airlines industry. Over the last five years as many airlines have reported record losses and five of the ten largest airlines have filed for bankruptcy, Southwest has been able to remain profitable and continue to grow.

While Southwest has gained market share in recent years, legacy carriers have struggled due to depressed market conditions. The entire airline industry has endured expensive labor contracts, soaring energy costs and reduced consumer demand. Southwest has continued to grow in the harsh airline industry because its no frills business model focuses on controlling costs. Southwest targets routes with high consumer demand and the advanced experience of Southwest's personnel allow Southwest to quickly turnaround aircraft and keep their planes in the air more hours per day than its rivals. Though the airline industry appears to be on the mend, Southwest has firmly positioned itself as a price leader and a strong market force with the lowest CASM of any airline.

Southwest has experienced remarkable growth in the airline industry by steadily taking market share from large legacy airlines. However, Southwest's success has brought considerable change to the market conditions of the airline industry. The struggling legacy airlines have been forced to streamline operations and new airlines with

aggressive low-cost strategies have entered the industry. Damaging price wars have forced many airlines to drastically alter their cost structure in order to remain competitive. By its success, Southwest has begun to alter the market conditions that were partially responsible for its success.

To ensure its future success, Southwest needs to maintain its cost advantages and find new growth opportunities. Even though Southwest has the most fuel hedging of any airline, those hedges only last through 2009. Fuel costs remain a major concern and Pandora Group recommends that Southwest take steps to improve the fuel efficiency of its fleet by purchasing new Boeing 737-700s. Southwest has considerable cash reserves and significantly less debt to total capitalization compared to other airlines which it should use to switch from renting Boeing 737-300s to owning Boeing 737-700s. In addition to fuel costs, labor costs are a primary concern for Southwest. In the next several years many of agreements for Southwest's 80 percent union force will up for negotiation. Southwest's success could lead its union workers to demand more generous compensation packages. Labor market conditions in the airline industry are such that Southwest will need to take a strong position with its unions to maintain/lower costs. Since Southwest has always maintained good relationships with its employees, it may be able to convince its employees to help in maintaining its low cost advantage. Pandora Group recommends that Southwest begin planning its strategy to do just that.

Pandora Group notes that Southwest's traditional strategy for growth may not continue to work in the future. Eschewing the hub airport strategy of the legacy carriers, Southwest traditionally selects only highly profitable city pair routes on which they can establish a strong market share through low prices and high load factors. However,

Southwest has already entered many of the most profitable markets. Pandora Group notes that growth opportunities still exist for Southwest in expanding operations in cities already serviced. Pandora Group also recommends that Southwest enter new cities especially those that have been serving as hubs for weakened legacy airlines. Pandora Group also encourages Southwest to expand by opening service to international destinations using their current operational strategy.

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