

# Review & Analysis

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## Issues Regarding AMR Chapter 11 Filing Key Points - From The Real World

### Background

The American Airlines bankruptcy filing is an event that injects a great deal of uncertainty into the planning process of airports, financial institutions, suppliers, and other entities in aviation. This document is prepared to provide our clients independent perspectives on the fallout that can be expected in the immediate future.

**Time For Some Facts. Not Guesses Postured As Expertise.** What has become obvious since the AMR filing is that the financial world is teeming with new analyst “experts” regarding the airline industry in general and American Airlines in particular.

Often, without the luxury of a shred of information on the specifics of the AMR filing, we have all sorts of advice and prognostications about AA from analysts who until last Tuesday were covering the technology sector, or the housing sector, or the paper products sector, but who now are qualified to pass on all aspects of American Airlines. Many of the missives put out by these sources indicate people whose knowledge of the airline industry ranks somewhere between zero and completely ill-informed.

This document is intended to provide our clients with hard information on which they can make reasoned decisions regarding the effects – if any – that the AMR filing may have on their respective sectors of the aviation industry.

It’s very clear that the information coming out of many parts of the financial world is less than useless.

- There are prognostications that AA can’t emerge from Chapter 11 because of competition, pricing, or other factors, most of which the “analyst” doesn’t understand in the first place.
- There are veneer reports that AA is in trouble because it’s not the #1 airline in size anymore. If size alone is the metric for survival, one may wish to contact a brontosaurus for details.

- There are articles noting that AA missed the “wave of consolidation” - without one shred of discussion as to what that’s supposed to represent.
- Some claim the filing offers huge market opportunities for competitors, but failing to mention how or where.
- Several “analysts” have declared that the Chapter 11 filing will allow American to shrink its system and drop “unprofitable routes.” Of note, they leave out the reality that AA doesn’t need a bankruptcy filing to do that. They also don’t explain how flying less will reduce either pension costs or debt expense – which are the core reasons for the filing.
- There are statements that American can benefit from a merger with US Airways, leaving out any support other than “it would reduce overhead.” No review of factors such as hub strength, market levels, or little things like labor and fleet integration, are mentioned.

Taking counsel in this type of expertise is akin to trusting the guy selling elixirs on a street corner. If this is the quality of “advice” and expertise typical to the financial world, consumers might do better to place their finances inside a Sealy Posturepedic.

## Scope

Over the past year, Boyd Group International has extensively analyzed the situation at AMR and American Airlines in several venues on an on-going basis. We have reviewed the cost challenges at AA v the rest of the industry. We have monitored and analyzed structural shifts, such as the “Cornerstone” strategy, the JAL and BA/Iberia joint business agreements (JBAs), we have reviewed the latest fleet renewal program at American, and we have extensively analyzed the conundrum represented by the American Eagle subsidiary.

The conclusions herein are those of Boyd Group International. This document has been prepared entirely independently and firm does not have business relationships with AMR or American Airlines. Furthermore – and very much unlike some of the financial analysts who opine on this merger - Boyd Group International has no financial investments in the airline industry.

The intent is to provide professional input in a clear, concise manner so that our clients affected by the AMR filing can have a better foundation on which to plan for the future.

## Overall Findings

- The AMR bankruptcy is aimed at resolving the burdens of pension costs and debt load. The operational structure, marketing strategies, and fleet applications are not a part of the objectives of the filing. None of those areas require a bankruptcy court to address.

Comments by some financial analysts that bankruptcy is “typically” used by airlines to drop unprofitable flying are flat ignorant – airlines can drop flying without any need for bankruptcy court assistance. The AMR filing has no utility whatsoever for reducing flying.

- While possible, it is not indicated that C-11 will be used to materially reduce the size of the mainline AA fleet. The current system has high load factors, and without the debt and pension burdens, it is strongly profitable.
- AMR will almost certainly move more aggressively to get rid of at least as many as 100 ERJ aircraft at Eagle as rapidly as possible. The “spin-off” proposal of Eagle is now off the table. AMR can address the excess RJ fleet within the bankruptcy route.
- The AA Cornerstone strategy is not directly affected by the filing.
- The potential for a merger with US Airways is no more or less likely (and no more attractive) than before the filing. While US Airways is a well-managed carrier, the comments by some financial types that there would be a strong fit between AA and US are essentially veneer analysis. Because of enormous pressure to “do a deal,” do expect, however, on some activity in this regard.

## FAQs & Insight

### **Q: What were the major drivers of this Chapter 11 filing?**

**A: Very simple: the combined weight of a defined benefit pension plan, and heavy corporate debt are now not sustainable due to the near-certainty of permanent and structurally higher fuel costs.**

- Note that in 2003, American restructured outside of a bankruptcy filing. The airline and its employee unions agreed to concessions that would keep the pension plans in place and would not shed responsibilities to current debt holders of AMR. This was in contrast to virtually all of AA’s competitors, which dumped such costs via bankruptcy filings between 2003 and 2006.
- At oil prices below roughly \$50, AA could support these costs. But with the specter of jet fuel being driven by \$100+ oil, the situation is untenable for the future.

### **Q: How heavy is the debt burden?**

**A: In light of high fuel costs, it is onerous. They are joined by employee pension, retiree medical benefits and include interest on debt against almost all encumbered aircraft.**

Since AMR chose to remain out of bankruptcy in 2003 (an honorable decision), it suffers debt obligations (including interest fulfillment and pension funding), not experienced by competing network airlines.

- Long-term AMR debt was \$9.4 billion as of June 2011, with \$1.7 billion in maturities by 2012.
- Interest payments comprise the largest non-operating expense, \$500 million by September 2011 year-to-date.
- Defined benefit pension funding is not an expense that AA's competitors must bear. Examples: AA has obligations of \$520M in 2011 and about \$560M in 2012.
- Because AA has not gone through Chapter 11 as its competition has, in 2010 it had the highest benefit cost per mainline employee of any of its competitors. Benefits include personnel related expenses, pensions and payroll taxes, but exclude salaries. Note: The ranking of benefit costs between airlines varies by year, and also by the schedule to which AMR makes periodic payments to its pension plan. In some years, AA has been lower than some other carriers. But the fact remains it still had the on-going obligation to its employees to make periodic pension contributions – a cost that competitors do not bear.
- Another point missed by the usual suspects working on the fringes of factual analysis, is that these benefit costs do not translate into bigger numbers on the employee pay checks. In fact, the reduction some tangible "benefits" incurred in 2003 - such as fewer holidays, lower holiday pay, reduced vacations, etc., effectively translate into lower compensation that is not reflected in the "net pay" window of the pay check.

**Q: What role did unions and union negotiations play in this need to file Chapter 11?**

**A: Essentially None. There have been on-going negotiations about pay and benefits, including an offer by the company to the pilots that included a reported increase in pay in exchange for changes in work rules. There is a tentative agreement in process with one of the groups represented by the Transport Workers Union.**

**What must be understood is that the proposals that were not accepted by the Allied Pilots Association would not have in themselves changed the reasons the AMR board opted for Chapter 11. If the latest proposal to the APA had been accepted, it would not have shifted the main reason for the filing. The pension burden was the result of the concession package negotiated between management and labor in 2003. As for the debt service, the unions at AA have no role whatsoever in how AA does its financing.**

- The media is reporting that AA has an \$800 million labor cost disadvantage over most of its competitors. The fundamental core of any labor cost disadvantage that AA may have is mostly the result of the defined benefit pension plan, and the fact that the airline and its unions jointly decided in 2003 negotiate agreements to avoid a bankruptcy filing. Since 2002, United, Delta, and Northwest all filed. In those re-organizations, labor was also forced to take very heavy hits in both pay and work rules.

- Another point not generally reported: the vast majority of AA rank-and-file employees have not seen paychecks grow to any meaningful degree since 2003, when they agreed to significant compensation reductions.

**Q: What major decisions will AMR make while in bankruptcy?**

**A: AMR's decisions will focus mainly on the pension issue and the debt load. There are no operational issues that Chapter 11 would facilitate. This filing is focused on the financial backroom, not the route map.**

- Operations – AMR is projected to continue normal operations for American Airlines and American Eagle. As will be noted below, the filing will allow AMR to shed the burdens of a financially-obsolete Eagle fleet in a more expeditious manner. This will affect some flying to smaller points on the route map, but these changes were coming eventually anyway, with or without a “Chapter” filing.
- Network – The Cornerstone airport hubs in Dallas/Ft. Worth (DFW), Chicago (ORD), Miami (MIA), Los Angeles (LAX) and New York (JFK) are strategic network anchors and have been/are to be strengthened.

**Q: What will this filing mean to airports served by the AA system?**

**A: As far as routes operated, nothing in the near term. We believe that AA will maintain its “Cornerstone” strategy, as it has nothing to do with any of the reasons for the filing. However, any airport where AA service is operated exclusively with Eagle should take a hard look at the market’s revenue performance.**

- To be sure, there are financial hits to airports that a C-11 filing will cause, such as non-payment of current bills, and the 90-day claw-back. However, at this time, other than a reduction in the Eagle fleet, the airline is not likely to reduce its route system.
- Airports with Eagle service: we strongly suggest a review of the revenues that the market is generating for the AA system. If service is with ERJ-135s or ERJ-140s, understand that these will be the first Eagle aircraft to be flown to the desert. Markets served with CRJ-700s are presumed to be safe, unless there is a reduction in the mainline fleet (retirement of more MD-80s than expected), where the 47 CRJs in the Eagle fleet could be shifted.

**Q: Won't AA use this as an opportunity to get rid of all their “gas-guzzling” MD-80s?**

**A: That is probably a common conclusion – particularly among the Wall Street types who simply don't know the difference between a maintenance reserve and the Federal Reserve.**

- It is certain that AA will put pressure on lessors to get better rates. Leases on stored aircraft will be rejected. It is also believed that all of AA's leases have 1110 provisions,

where AA can fly the aircraft for a period of time without paying rent, and make a decision at the end of the period to cure the past-due rent or just return the aircraft.

- It is certain that AA will likely use C-11 to dump some mainline aircraft. However, it will likely on a case-by-case basis. Some aircraft will likely see early lease terminations.
- It is likely that AA has already put pressure on lessors of MD-80s (or, in AA parlance, "Super-80s"). There is not much market for used MD-80s, and it is likely that any pressure to reduce lease payments would be successful.
- While high fuel costs are an issue with MD-80s, the elimination of pension and debt burdens would make AA profitable as it stands today, including the roughly 203 MD-80s still in operation.
- It has been speculated – correctly – that much of the paper collateralizing the MD-80 fleet is essentially worthless now. The unfortunate fact is that this collateral – the MD-80 fleet – had essentially only scrap value before the bankruptcy. Other than Allegiant (which just took another dozen or so MD-80s from SAS) there really are no second markets for MD-80s. Fine airplanes. Safe airplanes. But no buyers out there.
- The question is whether AA really wants to downsize an operation that can make money, especially since new airliners are coming down the line.

**Q: What might the AA fleet plan be, now that it's in C-11?**

**A: AA's new CEO stated the fleet renewal plan is "rock solid." That is about 100% accurate. It's near certain that the recent aircraft orders were accomplished with the vendors being well aware of the AA financial situation. In the real world, airliner financing is generated by airframers, powerplant manufacturers, and suppliers. They are not going to let any large order slip away, including that of American Airlines.**

- At the end of 2011, AMR is estimated to be operating 931 aircraft (614 mainline by American Airlines, 302 regional by AMR Eagle and 15 regional by Chautauqua/Republic Airways). This will decline to 789 units by 2025, with the reduction taking place entirely in what is today the Eagle fleet.

A preliminary estimate/forecast to 2025 of mainline aircraft, indicates about 733 mainline aircraft (up from 614 today), the result of:

- 437 current airliners being retired (all Boeing 757-200, 767-200 and MD82/83; some early Boeing 767-300, 737-800)
- 556 new deliveries (Boeing 777-200/300, 787-900, 737 NG and MAX, and Airbus 319/321 and 320 NEO)
- 119 net gain from swap one-for-one older aircraft and new orders

The 523 options (Boeing 787-900, 737 NG and MAX, and Airbus 319/321, 320 NEO) are excluded from the above forecast. They are wildcards that could come into play, but note that the mainline fleet, without these units, is projected to increase by almost 20%.

On the lower capacity end, what is today Eagle can be expected to have its wings clipped earlier than would have been possible without a Chapter 11 filing: A forecast to 2016 indicates a small jet fleet of only 56 aircraft:

- 246 retired (all Embraer ERJ 135/140/145, and some Bombardier CRJ 700 and ATR-72)
- The CRJs will start to be retired subsequent to 2016
- The A-319NEO will fill part of the “thin market” gap. The rest of the “gap” will simply not be economic to pursue. This will be an industry-wide dynamic.

Most of the above actions have been in motion pre-bankruptcy and will continue or culminate in to a definitive business plan post-bankruptcy.

**Q: What market and system changes will be seen as a result of the filing?**

**A: Other than an accelerated retirement of much of the Eagle ERJ fleet, probably very minor ones.**

- Some analysts may make the broad statement that this filing will allow AA to drop “unprofitable” routes, because that’s supposedly what airlines do in Chapter 11. **This is a clear sign of someone who really doesn’t know much about C-11.** First, “unprofitable” routes can be dropped without any need for entering bankruptcy. Second, AA has been in that process on an on-going basis for years.
- Alliance relationships – no changes in the AA role in the **oneworld** Alliance.

**Q: Is AMR financially strong enough to exit bankruptcy quickly and with gains?**

**A: Without question. AMR has adequate liquidity (cash and short-term investments) to finance its bankruptcy and to pay post-petition expenses. Its gains in the C-11 process will be a much more cost-effective operation and a more competitive global position.**

- As of 3Q 2011, AMR had about \$23 billion in total assets and \$4.3 billion in cash/short-term investments.
- AMR was wise to leverage internal liquidity to finance its bankruptcy. Because there is no DIP financing, there is no third entity that can be manipulated by outside interests during the reorganization process.

### **Q: How will AMR Eagle<sup>1</sup> be affected?**

**A: A lot of it will be moved out to the desert. AMR Eagle is, to be blunt, an economic millstone for AMR. A fine operator, but the majority of its fleet is made up of 50-seat and smaller jets. There are two big and growing challenges with these small aircraft. The first is fuel expense – as the cost of jet-A goes up, it disproportionately affects smaller aircraft that have fewer seats to sell. The second is growing maintenance costs as the aircraft age.**

- In the spin-off scenario postulated in the fall of 2010, the projection was that Eagle could eventually be free to bid other small lift provider (SLP) contracts, and AA could seek other SLP operators. The only problem with that scenario is that it describes a marketplace that no longer exists. Virtually all other major airlines also have a glut of small jets, and there are likely no such new-customer opportunities for Eagle. As for AA, the non-economics of 50-seaters precludes any chance it would seek to contract for more of these aircraft from anyone.
- With bankruptcy now filed, the rules are different. AMR can move more directly to ground excess ERJs. A sketched fleet plan shows 37-seat ERJ 135s and 44-seat ERJ 140s being retired first, closely followed by 50-seat ERJ 145s – these jets are rapidly becoming more and more economically-obsolete.

### **Q: Will this bankruptcy accelerate a merger with US Airways?**

**A: There is the misconception that AA must merge with somebody, simply because other airlines have done so. In many corners of Wall Street, that is the only reason and the total depth of the analysis regarding an AA merger. The fact is that US Airways would not bring much to the table – in fact, it has very little synergies with American.**

- Some have suggested that US Airways could be the domestic operation for AA, while the international would be operated by AA mainline. By all means, do not take anything seriously from such analysts. They obviously have no understanding whatsoever of the issues of fleets, unions, hub operations, maintenance programs, etc.
- Sheer size is not a true metric for airline health. But it seems that the AMR bankruptcy has created a whole garden industry of self-anointed airline industry experts. One quote from a Bloomberg article was particularly telling. Lamenting the fact that American is no longer the largest airline in the US, the writer confidently told readers: *"Only 15 percent of the passengers on U.S. carriers in October chose to fly American, compared with 21 percent for United and 20 percent for Delta."*

This factoid, which the "analyst" dug up, is meaningless. It is also incredibly ignorant of the airline industry. What is missed is that American today faces essentially the same

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<sup>1</sup> AMR Eagle comprises of American Eagle and Executive Airlines. American Connection is a separate entity.

competitive levels from Delta as it did when it faced a separate Delta and a separate Northwest. What this veneer expert doesn't recognize is that NW and DL before the merger were code-sharing and had interchangeable frequent flyer programs.

- **US Airways, a fine operator, does not offer much to the AA system.** The Phoenix hub is not particularly additive to AA, the PHL hub is competitive with the AA JFK operation, and CLT would mainly offer access to more small markets – which are difficult to serve economically. AA already has access to traffic at most mid-size and larger markets in the Deep South. As for feed – much of the international markets at CLT would compete with AA service at ORD, JFK, and MIA. The argument that CLT “would give AA access to the South” sounds appealing, but is largely bogus.
- There are no guarantees, however, that a shotgun marriage could not be arranged for the two carriers. Enormous amounts of money can be made in such deals, whether they make sense or not for the airline entities involved. If such a transaction were arranged, it would entail enormous amounts of additional “moving parts” and challenges for the combined entity to resolve issues such as labor contracts, re-structuring of entire revenue flows, and rationalizing fleets. There would be no near-term benefits.



## Fleet Forecast Projections

### Boyd Group International Projected AMR Fleet Forecast:

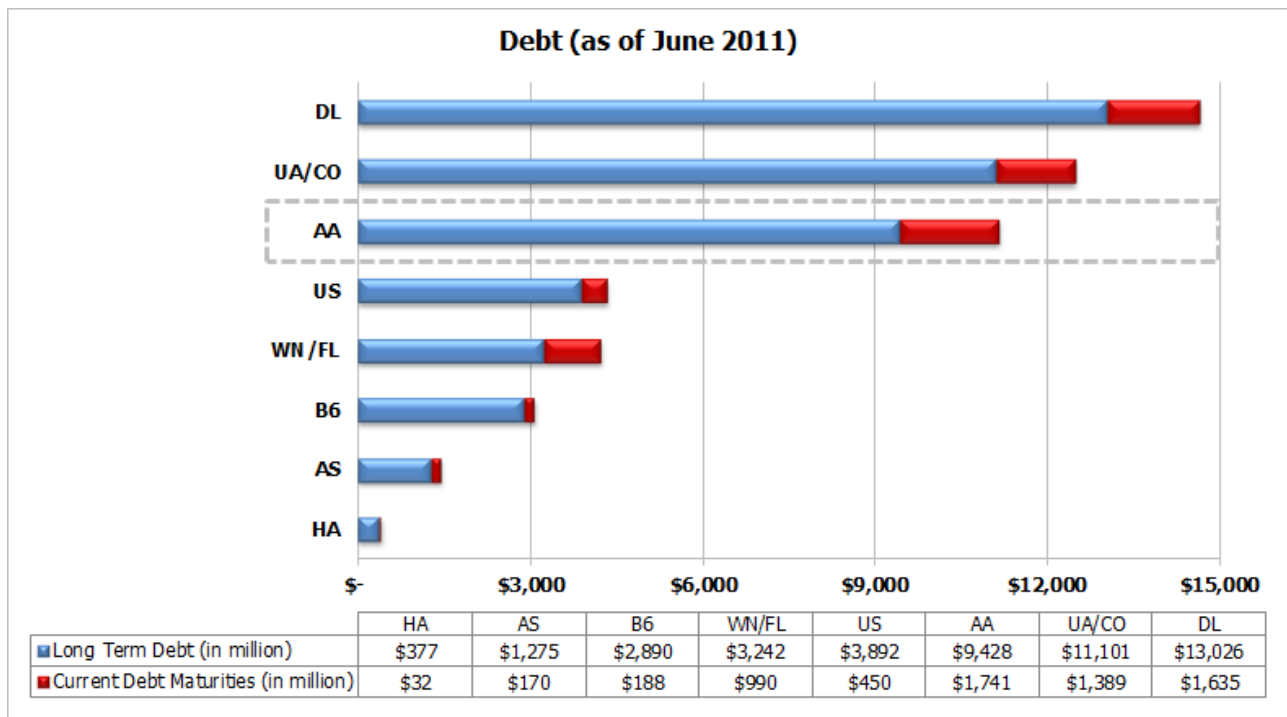
AA MAINLINE												
Aircraft Type	Avg. Age (2011, years)	Operating (end of 2011)	On Order	Retire (over 12-15 years; 2025)	Net Operating	Options	Seat Capacity	Seats (2011)	Change (vs. 2010)	% of Mainline Fleet	% of Mainline Capacity	% of Branded Capacity
MD-82/83	21	207		207	0		140	42,589,540	-8.4%	33.7%	39.2%	30.4%
767-200ER	25	15		15	0		168	1,770,367	-3.3%	2.4%	1.6%	1.3%
767-300ER	18	58		40	18		225	7,427,420	-9.5%	9.4%	6.8%	5.3%
777-200ER	11	47	6		53		247	5,036,955	-11.6%	7.7%	4.6%	3.6%
737-800	7	167	39	55	151		156	29,080,668	21.1%	27.2%	26.7%	20.8%
757-200	17	120		120	0		187	22,813,236	-0.3%	19.5%	21.0%	16.3%
787-900			42		42	58	250-290					
777-300ER			9		9		365					
737-700/800/900ER (NG)			100		100	40	180					
737-700/800/900ER (MAX)			100		100	60	180					
319/320/321			130		130	85	125-150					
320 (NEO)			130		130	280	150-185					
<b>TOTAL</b>	<b>15</b>	<b>614</b>	<b>556</b>	<b>437</b>	<b>733</b>	<b>523</b>		<b>108,718,186</b>	<b>-0.4%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>77.6%</b>

AMR EAGLE											
Aircraft Type	Avg. Age (2011, years)	Operating (end of 2011)	Retired by AA (over 5 years; 2016)	Net Operating	Seat Capacity	Seats (2011)	Change (vs. 2010)	% of AMR Eagle Fleet	% of AMR Eagle Capacity	% of AMR Branded Capacity	
CRJ-700	6	47	30	17	63/65	5,896,940	64.7%	15.6%	20.0%	4.2%	
ERJ-140	10	59	59	0	44	5,687,660	2.7%	19.5%	19.3%	4.1%	
ERJ-145	10	118	118	0	50	11,992,650	-6.7%	39.1%	40.6%	8.6%	
ERJ-135	12	39	39	0	37	1,422,132	-4.4%	12.9%	4.8%	1.0%	
ATR-72	17	39	0	39	64/66	4,533,312	-7.9%	12.9%	15.4%	3.2%	
<b>TOTAL</b>		<b>302</b>	<b>246</b>	<b>56</b>		<b>29,532,694</b>	<b>4.0%</b>	<b>100.0%</b>	<b>100.0%</b>	<b>21.1%</b>	

AA CONNECTION (CHAUTAUQUA-REPUBLIC)						
Aircraft Type	Operating (end of 2011)	Seat Capacity	Seats (2011)	% of Other Fleet	% of Other Capacity	% of Branded Capacity
ERJ-140	15	44	1,769,988	1.4%	100.0%	1.3%
<b>TOTAL</b>	<b>15</b>		<b>1,769,988</b>	<b>1.4%</b>	<b>100.0%</b>	<b>1.3%</b>

<b>SYSTEM</b>	<b>931</b>	<b>556</b>	<b>683</b>	<b>789</b>	<b>523</b>	<b>140,020,868</b>	<b>0.5%</b>	<b>100.0%</b>
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## AMR Financial Burden:



## Employee Benefits Comparison

Note: *These data reflect year 2010 only.* The actual amount per employee and the ranking varies year by year, depending on AMR's pension payment schedule. In some years, AA's per-employee number has been lower than some competitors. However, AMR still has the long-term pension-contribution obligation to its employees, which its competitors do not.

