

## What Makes Southwest Airlines Fly

How does Southwest Airlines keep making money? After all, the airline industry overall is in a shambles. US Airways and United Air Lines are reorganizing in bankruptcy while American Airlines flirts with the same fate. As a group, the nation's biggest air carriers have lost tens of millions of dollars over the past several years, with no immediate recovery in sight.

The secret to its success, said Southwest chairman Herb Kelleher during a talk at Wharton April 22, is available for anyone, including its competitors, to see. It's an obsession with keeping costs low and treating employees well and a commitment to managing the company during booms with an eye to the busts that will inevitably follow.

Do that, Kelleher said, and most of the rest takes care of itself. "To be successful in business, you need a sense of historicity and futurity," he said. "What does that mean? Hell if I know, but it sounds good. Seriously, what I'm saying is, be prepared because the bad times are going to come. In our industry, it happened twice in the last decade. It happened twice in the decade before that, and twice in the decade before that."

Though Kelleher was self-deprecating throughout his talk – he is famous for joking about his affection for whiskey – he did boast about his company's preparedness for the recent airline industry slump. "After Sept. 11, we didn't cancel any flights," he said. "We didn't furlough any employees."

Southwest could do that because it had the lowest costs and strongest balance sheet in its industry, according to Kelleher. On Monday, the Dallas-based company reported its 48th consecutive profitable quarter, earning \$24 million, or 3 cents a share, up 14% from the comparable quarter a year earlier. Its stock closed Tuesday at \$15.67 a share. Over the last five years, its shares have gained 67%, compared with a 61% loss for the Dow Jones Airline Index. The company, Kelleher states, has made money every year for the last 30.

Close attention to costs produced those results, he noted. "Even in the best of times, we kept our costs low and questioned every expenditure. For years, I used to approve every expenditure over \$1,000. Why? To encourage a cost-conscious culture. I couldn't look at all of them, of course. But I would question them selectively, and that kept people paying attention."

Low costs have given Southwest its market niche – and its competitive advantage – of having the nation's lowest fares. And that, in turn, has created a phenomenon known in the airline industry as the "Southwest effect." Airports served by Southwest have lower average fares than those that aren't because other carriers feel compelled to match Southwest's fares.

Compare, for example, two otherwise similar metro areas, Raleigh-Durham, N.C., and Charlotte, N.C. Southwest operates in Raleigh but not Charlotte, and Raleigh's fares are typically half that of Charlotte, which is a hub for US Airways. And contrast both of those with Love Field in Dallas, which has the

lowest average fares in the country. "What's significant about Love Field?" Kelleher asked. "It's served only by Southwest Airlines. If you're going to be a low-fare airline, you have to charge low fares even where you don't have competition."

Concern about costs is also the reason that Southwest keeps its debt at the lowest level in the airline industry, with a debt-to-equity ratio of 25% (40% if airplane leases are included). "Interest is ugly," he said. "The banks still want to get paid in bad times."

If a CEO instills the right kind of culture, employees will work hard, too, at keeping costs low, Kelleher said. Consider the Southwest counter agent in Los Angeles who lent a stapler to a colleague at another carrier. "Our agent followed him over to his counter and said, 'I want to make sure we get that stapler back because if we don't it's going to hurt our profit sharing.'"

The tale points to the second reason why Kelleher believes his company has succeeded: its treatment of employees. "It's sometimes been held out to be a conundrum in business - 'Who comes first, employees, customers or shareholders?' We've never thought it was a conundrum. If employees are treated well, they'll treat the customers well. If the customers are treated well, they'll come back, and the shareholders will be happy."

At Southwest, treating employees well doesn't mean handing out big paychecks. In fact, the company's wages are lower than competitors. But the airline makes stock options widely available, so all employees - not just executives - can share in the company's financial success.

Southwest even has a policy that its officers receive pay increases that are no larger, proportionally, than what other employees receive. "And in bad times, we take reductions," Kelleher said. "Every officer of Southwest Airlines is paid less today than in 2001."

Good treatment also translates to a variety of non-financial measures. The most important of them is the company's no-layoff policy. Kelleher says it ends up serving as a form of financial discipline because it prevents managers from hiring too many people when the industry is thriving. Having happy employees saves money, too. It has stemmed labor strife at Southwest, despite the fact that the airline is the country's most unionized. "Once labor leaders realize that you're trying to take care of your people, most of the edge [in contract negotiations] is gone."

If Southwest's strategy is easy to explain, it has proved hard to copy. US Airways, for example, tried with its MetroJet subsidiary, but failed. "They said they were going to be a low-fare airline, but they weren't a low-cost airline." The venture folded.

New York-based JetBlue Airways and Song, a new low fare-subsubsidiary of Atlanta-based Delta Air Lines, are currently trying the same approach. Kelleher isn't concerned. "The one thing JetBlue has that we don't is on-board TVs, but we have lower costs."

Southwest has never shied away from doing things its own way. Early on, this meant flying only Boeing 737 jets, so that every pilot, crew member and mechanic would be familiar with every plane in the fleet. Lately, it has meant

refusing to let its fares be published on travel websites such as Orbitz, Expedia and Travelocity. Southwest doesn't want someone else to control its distribution of tickets, Kelleher said. Plus, "Orbitz is a consortium owned by our competitors. And they do charge for it; it ain't free."

Some industry analysts predict that a major air carrier will have to cease operations before the remaining companies can make money again. The thinking is that the industry simply has too much capacity – too many seats and too few travelers.

Kelleher disagrees. For him, as always, the key is costs. "Traffic depends on fare levels," he said. "And you can bribe passengers to fly." In other words, if fares are low enough, more people will take to the air. Southwest saw that after it initiated service between Baltimore and Chicago. Since then, overall traffic between the two airports has increased by more than 2,000%.

But he points out that for carriers to make money on lower fares, they will have to lower their costs. And that may prove difficult. After all, the airline business is one of the toughest in America. It's capital intensive because planes are expensive. It's labor intensive and requires highly skilled workers.

And it affords little wiggle room because its inventory – empty seats – expires every day when its planes take off. The industry is also highly regulated – by the Federal Aviation Administration and now the Transportation Safety Administration – and highly taxed. Airline-specific fees account for a third of the price of a Southwest ticket, Kelleher said. "I go to Washington and tell them, 'You're taxing us more than cigarettes and whiskey, and that's a triple whammy for me.'"

But even in a tough, cyclical industry such as this one, a well-run company can make money for its shareholders, Kelleher maintained. *Money* magazine last year identified Southwest as the American company that has given the greatest return to shareholders over the last 30 years. According to Kelleher, "If you had invested \$100,000 in 1972, it would have grown to \$102 million by 2002."

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