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May 03, 2010

How the Continental-United deal went down

In the end, **the biggest airline merger in U.S. history** came together in three weeks. Continental and United had danced two years ago and decided against combining. But just months after Jeff Smisek took over as CEO of Continental, things changed.

Chronicle file photo
Smisek: can he make this deal fly?

United, which had previously invited Continental to join the Star Alliance, once again began making merger overtures with US Airways. On April 9, which happened to be United CEO Glenn Tilton's birthday, Smisek called him.

"You're headed down a path that I think might not be optimal," Tilton said Smisek told him.

United quickly threw aside USAir for Continental. From there, the deal moved fast because the two airlines already knew each

other so well.

"Time is the enemy of deals," Tilton said. "We had to go to work fast. This deal came together at warp speed."

Now, employees, customers and shareholders are trying to assess what the two executives have wrought. Wall Street, of course, loves the deal, but then it always does. Bankers, after all, get to collect fees and walk away. Smisek insisted that concern for long-suffering shareholders was a big driver behind the deal.

"Both Glenn and I have done a terrible job returning value to our shareholders," he said.

But as I note in today's column, **history is against him.** Airline mergers rarely generate lasting value for investors.

Smisek and Tilton argue the merger is predicated heavily on revenue. That is, they hope to improve the mix of business travelers and increase the new United's overall profitability by attracting higher paying passengers. It's unclear whether that will offset the costs.

Airline mergers historically don't generate the savings that executives predict, and in this case, Continental, which hasn't been through bankruptcy since the mid-1990s, has one of the highest cost structures in the industry.

Smisek said the deal will lower costs and make the new United more competitive, both internationally and with low-cost carriers at home.

But the competition is stiff. The 2008 merger of Delta Air Lines and Northwest Airlines, both of whom had been through bankruptcy, has created what will be the No. 2 airline with lower costs than either Continental or United have now. In other words, the biggest rival to the new United may still have a competitive advantage.

In the airline business, the carrier with the lowest costs tends to win.

Technorati Tags: **airlines**,**mergers and acquisitions**,**Continental Airlines**,**United Airlines**,**business**

Posted by Loren at May 3, 2010 11:23 AM
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May 05, 2010

Airline dog fight: Continental vs Continental

One of things often gets over looked in discussing Continental's turnaround after its mid-90s bankruptcy is the innovation it brought to the industry. In fact, Continental fostered an innovative culture even during the Frank Lorenzo years.

Bloomberg News

Lorenzo may be loathed by employees, but many of the financial tools employed during his tenure, such as selling planes and leasing them back, have become standard industry practice. The tactic enabled the carrier to modernize its fleet even though it didn't have a lot of cash, said Michael Cox, a former Continental treasurer who's now managing director of the Seabury Group, which advises airlines on restructuring.

Cox described Continental's culture as "very entrepreneurial," and it's a spirit that has survived to this day. In fact, it's the spirit that Continental CEO Jeff Smisek hopes he can transplant to United.

Not only did Continental wind up exporting financial innovation, it's reputation for develop good managers has also made it an exporter of executives with

expertise in airline finance and operations. That sets up an interesting showdown among the soon-to-be No. 1 and No. 2 carriers.

The new United will, of course, be run by Jeff Smisek and the Continental management team. It's next biggest rival, Delta Air Lines, also has three former Continental executives in top jobs:

-- Richard Anderson, Delta's CEO, worked in Continental's legal department in the late 1980s before leaving for Northwest in 1990.

-- Glen Hauenstein, Delta's executive vice president for network planning, handled Continental's scheduling and network operations from 1998 to 2003.

-- Michael Campbell, Delta's executive vice president of human resources and labor relations, oversaw the same functions at Continental from 1997 to 2004.

On Tuesday, Smisek met with the Chronicle's editorial board and said of Delta: "They want to kill us."

Once the United deal is complete, airline competition may be more like a family feud.

Technorati tags: **airlines**, **mergers and acquisitions**, **Continental Airlines**, **United Airlines**, **Delta Air Lines**, **business**

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October 05, 2010

Up, up and away with airline executive pay

As the merger of Continental and United airlines closed on Friday, chief executive Jeff Smisek told the Chronicle **"I hope to receive a salary this year."** Smisek said in January **he would waive his $730,000 salary** unless Continental was profitable.

Johnny Hanson / Houston Chronicle
Smisek: some extra cash in that carry-on?

Now, he appears to be giving himself a raise. In **a filing with the Securities and Exchange Commission**, the new United Continental Holdings outlined pay for its top executives. As Theo Francis pointed out at Footnoted.org, **upper management is padding its collective wallet** on this deal:

> Jeffrey Smisek, who had just been made Continental's CEO on January 1, will be pulling in a salary of $975,000 -- up by two thirds from the $590,400 he made last year at Continental, and still 33% more than [Larry] Kellner, his predecessor there, judging from the company's **most recent proxy**. Zane Rowe, Continental's former CFO and now CFO of UAL, is seeing a salary increase to $750,000 from $383,908 last

> year. James Compton, who now seems to be "chief revenue officer" after serving as Continental's chief marketing officer, also saw his salary nearly double to $750,000. Peter McDonald, the combined airline's chief operations officer and one of the few holdovers from the old UAL's top echelons (he was chief administrative officer there), didn't do quite so well: His salary is going up just 11%, but from a pretty high base, as this year's **proxy** shows -- he'll be making $850,000.

That, of course, is just salary. Then there's the bonuses:

> Target bonuses for all of them top $1 million. By contrast, Rowe and Compton took home cash incentive pay of $863,793 apiece last year. (Isn't it nice when several executives are paid the same salary and then somehow manage to earn *exactly equal* performance bonuses?) McDonald, like all of the old UAL's execs, got no cash incentive pay in 2009.
>
> Smisek, meantime, has an annual bonus target of $1.46 million -- plus another $8.4 million long-term incentive award, and a $4 million " one-time merger integration incentive" based on yet-to-be-determined integration goals.

And if the new airline is serious about cutting costs and decides that some of the fat in the executive offices needs to go? Well, that won't be cheap, either:

> Cash severance alone for Rowe and Compton would come to $4.8 million apiece if they're let go without cause over the next two years, plus health-care for 33 months. Firing Smisek would cost $6.7 million cash on the barrelhead, and potentially health benefits until he's eligible for Medicare. (After two years, the cash severance costs would fall -- to about $3.5 million for Rowe and Compton, and $4.9 million for Smisek, plus benefits for two years.)

In the past, I've been reluctant to criticize executive pay in the airline business. Running an airline, I've argued, is among the most thankless jobs in Corporate America, in part because executives often forego salaries to appease workers who've had to submit to concessions.

Sure, Smisek will be running a bigger airline - in fact, the *biggest* airline - and perhaps that fact alone warrants a raise. But this merger is still in its infancy, and there's still a lot that could go wrong and wind up costing shareholders. It's a little early for management to be rewarding itself.

Posted by Loren at October 5, 2010 04:46 PM
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October 12, 2010

Why Southwest won't start charging for bags

Southwest Airlines has had some memorable commercials over the years. One of my favorites was from the late 1970s or early 1980s. Former chairman Herb Kelleher was standing by the highway with a megaphone shouting at passing drivers: "Surrender your allegiance to the wheel!" More recently, the carrier had made marketing hay with ads that feature its baggage handlers as cops, shaking their heads at the egregious baggage fees charged by other carriers.

Last week, I asked Southwest chief executive Gary Kelly if Southwest planned to change its policy, given that it's competitors have gotten such a big revenue boost from fees on bags and other services.

Melissa Phillip / Houston Chronicle

Gary Kelly: pro-luggage

Kelly described Southwest's decision to hold out against the fees as a "leap of faith," but one that has proven more successful than he imagined. Customers see the fees as a "gotcha," a deception.

"It's been a rallying cry," he said. "We've seen a very significant market share shift." Passengers hate the fees so much, they booking on Southwest to avoid them. It's easy to understand why. For a family vacation, bag fees can add hundreds of dollars to fares.

"People are infuriated with that kind of treatment," he said. "I'm a little surprised at how aggravated people are. We've had congressional hearings on the topic."

He estimates Southwest has gained about $700 million a year in additional booking revenue simply by not charging the fees. "It's huge," he said. "It's indisputable."

Analysts initially criticized Southwest's decision to hold out, but they're beginning to recognize that the carrier gets more revenue from not charging the fees. Kelly said keeping customers is more important.

Besides, given the high fees some of its competitors are charging, Southwest could even bump up fares by $10 or $20, and still undercut their competitors when fees are included.

Much of my discussion with Kelly focused on the AirTran merger and how Southwest has changed in the past decade. I'll have more on that in tomorrow's column. The carrier's refusal to charge bag fees, though, is a classic Southwest move,

Posted by Loren at October 12, 2010 08:28 AM
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December 28, 2010

Alfred Kahn's legacy of air travel

Alfred Kahn, the Cornell University economist considered by many to be the father of airline deregulation, **died yesterday** at his home in Ithaca, N.Y. Kahn, who was 93, had cancer, according to **an obituary on Cornell's web site.**

Kahn became the chairman of the Civil Aeronautics Board under President Jimmy Carter and led the charge to bring free market pricing to the airline industry. By then, airlines were already becoming more competitive, but Kahn believed air travel should be more affordable, and that by encouraging competition, prices would fall.

Sen. Edward Kennedy, D-Mass., later took up the call, and helped push through the Airline Deregulation Act of 1978.

Airline deregulation, of course, is often cited for many of today's flying hassles - overcrowded planes, lousy service, few amenities. But Kahn's goal of making air travel available for everyone was achieved.

``The purpose was to bring it within the reach of people with limited income,'' he told me in 2003.

Kahn estimated that deregulation brought $20 billion worth of benefits to consumers. As for the poor service, frequent bankruptcy of carriers and other problems that have pervaded the industry, Kahn was unapologetic.

"It's given people choices of low-quality services at low prices," he said. ``We did not suspect that [that industry] would cease to be subject to the business cycle. Some people lost a lot of money -- well, that's got nothing to do with it."

The airline business remains something of a competitive anomaly. Unlike many other industries, bankrupt competitors tend to thrive under court protection, and often set the pricing ceiling for healthier carriers, dragging down profits for all carriers.

The result has been relentless cost-cutting that has shed thousands of jobs and left airlines with so little capital that they've been slow to adopt innovations that would make them more efficient.

Kahn's efforts to bring competition to commercial aviation drew the ire of airline executives at the time, who accused him of trying to ruin the business. Kahn famously admitted he couldn't tell one type of aircraft from another, saying he saw all airplanes as "marginal costs with wings."

The industry's persistent problem with competition, Kahn noted, wasn't the point of bringing airlines into the free market.

``All I predicted was if you let them compete, they'll find a way to fill those empty seats, increase productivity, make their route structures more efficient," he said. "In that sense, they have succeeded tremendously."

Technorati Tags: **airlines**,**deregulation**,**Alfred Kahn**,**economy**,**business**

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