The Amazing JetBlue

Whitney Tilson is an unabashed fan of newcomer airline JetBlue. In this first column in a series, he highlights the company's remarkable success to date.

By Whitney Tilson
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I'm a frequent flier and, over hundreds of flights in past years, had developed little or no loyalty to any airline; they were all pretty much different degrees of lousy (my opinion is apparently widely shared, as airlines accounted for six of the top 10 complaints at eComplaints.com according to an article I read).

But today, I'm almost embarrassed to admit, I'm crazy about **JetBlue** (Nasdaq: JBLU), the discount airline that started flying out of New York's JFK airport in early 2000.

JetBlue offers more than just phenomenal prices, which always used to be enough to win my business, but not my loyalty. The planes are brand-new, the overhead bins are huge (I *hate* being forced to check my carry-on bag), the leather seats are reasonably comfortable, 24 channels of live TV help the flights pass quickly (and entertain the kids), and -- this is critical -- the service is fantastic. I hope you're sitting down, but the flight attendants are actually *nice!*

And if something goes wrong, JetBlue tries to make it up to you. For example, on a recent flight, the pilot reported that a light in the cockpit was malfunctioning, which led to a 45-minute delay. We were all starting to get pretty unhappy until the maintenance guy came on board, told us that the problem was fixed, and said that everyone on the flight would receive a $50 credit on a future flight, which led to widespread clapping. I was actually happy about the delay!

It won't surprise you to hear that JetBlue has been growing like gangbusters and earning huge profits.

Having studied JetBlue carefully and flown it roughly two dozen times, I'm convinced that it is not only the greatest airline I've ever encountered, but one of the finest businesses in the world. Seriously. Not in the sense that its margins or competitive advantages can rival those of, say, **Microsoft** (Nasdaq: MSFT) or **Pfizer** (NYSE: PFE), but rather that its strategy, execution, culture, customer service, and success relative to its industry are among the most impressive I've ever seen.

Thus, I think every entrepreneur, businessperson, and investor should study JetBlue carefully because it is a fascinating, illuminating case study in ways that I will highlight in this and subsequent columns.

Incidentally, I have never owned the stock, nor am I considering buying it at its current price (it closed yesterday at $39.71, equal to 36.1 times this year's consensus analysts' estimates of $1.10), but I will pay it a great compliment: If I were forced to buy one stock trading in excess of 35 times this year's estimates, it would be JetBlue.

Why? Because I think the company will continue to rapidly steal market share from the dinosaurs in this industry, making it a good bet to grow to five to seven times its current size in the next eight years (based on the number of planes it has on order), which translates into 19%-25% compounded annual growth. If it can maintain anything close to its current margins and P/E multiple (big “ifs”), the stock will be a fabulous investment.

Background

JetBlue was founded by industry veteran David Neeleman (though he’s only 43), and is modeled after hugely successful **Southwest Airlines** (NYSE: LUV), for which Neeleman briefly worked after selling Morris Air to Southwest in 1993 and before going on to create wildly successful WestJet in Canada. Like Southwest, JetBlue has a low cost structure, flies one type of aircraft (brand new Airbus A320s), does not offer first-class seating, flies point-to-point (shunning the hub-and-spoke system used by the major carriers), sticks mostly to secondary airports, and has created a unique culture that translates into superior customer service.

But there are some significant differences as well (all figures as of Q1 ‘03 unless otherwise noted): JetBlue flies bigger planes (seating 162 vs. 132) and longer routes (1,169 miles vs. 723 miles on average), resulting in higher revenue per flight ($14,089 vs. $5,796) and lower ticket prices (passenger revenue per mile flown was 8.8 cents at JetBlue vs. 12.0 cents at Southwest). Also, JetBlue is not unionized, whereas 85% of Southwest’s employees are, which contributes to lower labor costs as a percentage of revenues (26% vs. 38%; the major carriers are well into the 40%-50% range).

Comparison

To see how truly spectacular JetBlue is, let’s compare it to Southwest, the industry gold standard that’s been profitable for 30 consecutive years, and **Delta Air Lines** (NYSE: DAL), which is considered one of the better major carriers -- though that’s not saying much (combined, the major carriers managed to lose more than $10 billion last year).

	JetBlue	Southwest	Delta
Oper. margin (%)	15.9	3.4	-17.0
Net margin (%)	8.0	1.8	-14.9
Labor cost/rev. (%)	26.2	38.2	51.8
Rev. growth (YOY %)	62.8	7.5	1.7
Net income growth (YOY %)	33.5	14.3	-17.2
Cash flow from oper. ($M)	31.0	267.0	-165.0
Net debt/equity ratio	1.1	*	18.7
Load factor (%)	81.4	62.6	68.9
Aircraft util. (hrs/day)	13.0	11.0	9.0
Oper. revenue yield/ ASM (cents)	7.42	7.77	9.50
Oper expenses/ ASM (cents)	6.25	7.50	11.11
Margin/ASM (cents)	1.17	0.27	-1.61
Margin/ASM (%)	18.7	3.6	-14.5
% booked thru website	71.0	50.0	n/a
May traffic (RPM; YOY %)	74.1	3.2	-9.4
Revenue/RPM (cents)	8.8	12.0	12.8
P/E ratio (2003 estimates)	36.1	49.7	n/a
P/E ratio (2004 estimates)	26.1	30.2	n/a

Notes: All data is for Q1 '03 except May traffic; Southwest has no net debt ($1,889 in cash and $1,679 in debt); aircraft utilization figures for Southwest and Delta are estimates drawn from newspaper articles; Delta is projected to lose $8.80/share in 2003 and $2.96/share in 2004. YOY: year over year;
ASM: available seat mile, total of all seats available on every airline route, multiplied by the length of the route (a benchmark of an airline's total capacity);
RPM: revenue passenger mile, number of seat-miles for which the airline is actually filling a seat and making money; load factor: RPM/ASM (higher is better).

To summarize, JetBlue is charging very low prices (as evidenced by the low passenger revenue/RPM), leading to full planes (high load factor). Combined with exceptionally low costs (operating expenses/ASM) and exceptional utilization (its planes are in the air for 13 hours a day), it is able to make unheard-of margins despite charging so little.

This creates a virtuous cycle whereby more passengers are flocking to JetBlue, which lowers per-passenger costs (operating expenses/ASM fell 8.2% YOY in Q1 '03, despite a 57% increase in average fuel cost per gallon) and allows the airline to charge even lower prices (revenue/RPM fell 11.1% in Q1) and drives even more traffic.

The end result is that, unlike most other airlines, JetBlue is growing rapidly, generating healthy profits and operating cash flow, and maintaining a strong balance sheet.

Do these characteristics remind you of another wildly successful business? Think about **Wal-Mart** (NYSE: WMT) and its amazing history. Starting with one store in 1950 in northwestern Arkansas (Sam Walton's Walton's Five and Dime; the first Wal-Mart opened in 1962), Wal-Mart has grown to be the world's largest company (by revenues) by building a strong culture, providing exceptional service, and offering great value and low prices.

JetBlue doesn't just talk about doing the same things -- it is actually doing so, which is why I believe it has a decent chance to become the Wal-Mart of the airline industry over time.

Conclusion
The most interesting question is: *How* has JetBlue achieved such remarkable success to date? What is it about the company that has generated such customer loyalty? How has it created a positive culture and outstanding customer service, especially in an industry known for dreadful labor-management relations and pathetic service? What accounts for such low costs? How has its strategy created competitive advantages, and how sustainable are they? Finally, what can go wrong?

I will address these critical questions in future columns.

Whitney Tilson is a longtime guest columnist for The Motley Fool. He did not own shares of the companies mentioned in this article at press time, though positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your feedback on the Fool on the Hill discussion board or at Tilson@Tilsonfunds.com. The Motley Fool is investors writing for investors.

JetBlue's Beautiful Cost Structure

Whitney Tilson continues his series on JetBlue Airways. A remarkably low-cost structure has allowed the newcomer to undercut competitors, gobble up market share, and rapidly expand, all while maintaining industry-leading profit margins.

By Whitney Tilson
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In The Amazing JetBlue, I highlighted the upstart's remarkable success to date. There are reasons aplenty. **JetBlue** (Nasdaq: JBLU) was the best-capitalized startup in industry history. The airline serves lucrative, high-volume markets, and most of its competitors are ill-managed and heavily in debt. By offering customers an exceptional experience, JetBlue has fostered brand loyalty in what had become a commodity industry.

But let's not overlook the single most important driver of the airline's success: JetBlue charges considerably less than just about any other airline. In the industry, analysts track what's called passenger revenue per revenue passenger mile (RPM). In English, that's what an airline charges the average paying customer to fly one mile. For JetBlue, in 2002, that number was 9 cents.

By contrast, **Southwest Airlines** (NYSE: LUV), the industry gold standard for discount fares, charged 11.8 cents/RPM, 31% more than JetBlue, though, admittedly, this difference is largely due to the fact that JetBlue's average flight is 60% longer. **Delta Air Lines** (NYSE: DAL), considered one of the better major carriers, charged 12.1 cents/RPM, 34% more than JetBlue -- though this, in part, reflects Delta's first-class seating and other perks. It's little wonder customers are flocking to JetBlue. In June, passenger counts soared 61% year over year and planes flew at an exceptional 87% of capacity.

With its focus on high volumes and rock-bottom pricing, one might assume that JetBlue runs a low-margin business -- think **Costco** (Nasdaq: COST) or **Wal-Mart** (NYSE: WMT). In fact, that wouldn't be so bad, given that last year major carriers rode large *negative* margins to a collective loss of more than $10 billion. But JetBlue's operating margins are remarkably high -- 16.5% in 2002. By contrast, Southwest's was 7.6% and Delta's a *minus* 9.8%. The differences in Q1 '03 were even more dramatic: JetBlue, 15.9%; Southwest, 3.4%; and Delta, -17.0%.

So, how does JetBlue charge the lowest prices and still earn the highest margins? Simple: Its costs are the lowest, by a long shot.

At the risk of losing you with more industry jargon, airline costs are typically measured by dividing operating expenses by available seat miles (ASM). In other words, how much an airline spends, on average, to fly each seat (whether filled or not) one mile. For JetBlue, in 2002, that was 6.43 cents. The same thing cost Southwest 7.41 cents/ASM (15% more than JetBlue) and Delta 10.31 cents/ASM (a staggering 60% more than JetBlue).

What's behind this huge cost advantage? Let's examine the income statements of these three airlines, converting all expenses into cents/ASM:

	JetBlue	Southwest	Delta
TOTAL REVENUES	7.71	8.02	9.39
OPERATING EXPENSES			
Salaries, wages, and benefits	1.97	2.89	4.35
Fuel and oil	0.93	1.11	1.19
Maintenance materials and repairs	0.11	0.57	0.50
Aircraft rentals & depreciation	0.82	0.79	1.31
Landing fees and other rentals	0.53	0.50	0.59
Other operating expenses	2.08	1.56	2.37
Total operating expenses	6.43	7.41	10.31
OPERATING INCOME	1.27	0.61	-0.92

* year ended Dec. 31, 2002

From this, we see that JetBlue's much lower costs more than make up for moderately lower revenues, resulting in more than *twice* Southwest's operating income/ASM. (Let's not even talk about the disasters at Delta and other major carriers.)

We also see that JetBlue's lower costs are driven by two key elements: lower salaries, wages, and benefits (highly productive people); and lower maintenance and aircraft rentals and depreciation (highly productive aircraft).

Essentially, there are three ways a company can improve return on equity: (1) raise profit margins (increasingly difficult in an environment where companies are struggling merely to maintain their margins); (2) increase leverage, which adds risk (and corporate America is already at record-high debt levels); or (3) increase asset utilization (sales/assets). It is in the last -- maximizing the productivity of assets (including human assets) -- that JetBlue schools other companies and industries.

Productive people

JetBlue achieves tremendous labor productivity in a number of ways:

1. Employees feel valued and respected and have a sense of ownership, which translates into a motivated, productive workforce. How JetBlue has achieved this in an industry infamous for catastrophic labor-management relations is a topic I will address in a future column.

2. Workers aren't unionized so there are no restrictive work rules.

3. JetBlue flies one type of aircraft, which keeps training costs down, improves productivity, and increases scheduling flexibility.

4. On average, its pilots are paid for 83 hours per month, of which 82% are "block hours" -- the time from when a plane pushes back from one gate and arrives at another. This is a critical measure of pilot productivity since an airline only earns money during block time. JetBlue maximizes this metric primarily by reducing training time (again, flying one type of plane) and by shunning the industry-standard hub-and-spoke system and its associated delays between flights.

5. Finally, while JetBlue doesn't advertise this, its salaries are lower. The average JetBlue captain earns $135,000 annually (including overtime pay) vs. $149,000 for Southwest and $245,000 for

Delta. Flight attendants start at $20 per hour and reservations agents at $8.25 per hour, though they work from home, saving overhead and contributing to employee satisfaction.

Wage discrepancies are not so great as they initially appear, however. Flight attendants and pilots earn time-and-a-half overtime above 70 flight hours per month, and there is ample opportunity to work extra hours (the average flight attendant works 89 hours per month). In addition, the company contributes 15% of its pre-tax income to a crew member profit-sharing plan, which last year translated into a 15.5% bonus for all employees. Finally, there's a generous stock purchase plan for employees, with nearly 70% participation, and some get stock options.

Other factors offset the lower pay at JetBlue. For one, there's a high degree of job security. There are also opportunities for advancement. For example, pilots can be promoted from first officer to captain in as little as three years -- virtually unheard of in this rapidly downsizing industry. And with JetBlue growing so fast, new employees quickly gain seniority and its associated perks: choosing which days and routes to fly, avoiding dreaded "red-eye" flights, etc. As a result -- and, of course, with all of the layoffs in the industry -- JetBlue is deluged with job applications. The company has 6,000 pilot applications on file, approximately 12 times the number of pilots hired to date.

A JetBlue flight attendant who used to work for United tells me that while her base pay is lower, she makes it up by working overtime and participating in the stock purchase plan. She likes working for JetBlue because the company treats her well, she is already quite senior (meaning that she has her pick of routes), and her fellow flight attendants work as hard as she does. At United, she said relations with management were terrible, she was among the most junior flight attendants (which was why she was laid off), and was often frustrated by burnt-out, unmotivated colleagues who -- knowing that their union would protect them -- were rude to passengers or simply sat at the back of the plane during the bulk of the flight. I don't want to read too much into one anecdote, but I suspect that her story is typical.

Productive planes

Given their high cost, it's critical to squeeze every ounce of productivity from each airplane. To keep aircraft operating costs low, JetBlue buys only new planes, which tend to need less maintenance and, even better, come with a five-year warranty. There's a rumor going around that Airbus is giving JetBlue planes for free, which is obviously untrue -- though I don't doubt that JetBlue gets excellent prices.

Equally important, JetBlue keeps its planes in the air -- the only time when they're earning revenues -- an average of 13 hours per day. This is the highest in the industry, 18% higher than Southwest (11 hours, though again this is largely due to JetBlue's longer flights) and 44% more than Delta (9 hours).

JetBlue achieves this productivity because:

1. Its planes are at the gate for, on average, 35 minutes, vs. an hour or more for most airlines. This is partly because flight attendants are expected to help clean the plane, which motivates them to be persistent in encouraging passengers to pick up trash *before* the plane lands. Also, as noted above, JetBlue shuns the delay-causing hub-and-spoke system.

2. New aircraft tend to spend less time out of commission due to unexpected breakdowns and scheduled maintenance.

3. With many coast-to-coast routes, JetBlue flies many planes on all-night "red-eye" flights. By my count, 17 of JetBlue's 44 aircraft (39%) are in the air at some point between midnight and 6 a.m. every day.

Low distribution costs

JetBlue further benefits by selling 71% of its tickets via its website, vs. just 50% for Southwest and far fewer for most major carriers. It encourages this by offering a $5 discount per ticket. In addition, it pays no commissions to travel agents and issues no paper tickets whatsoever, which saves $5 to $7 in processing and distribution costs.

The ways in which JetBlue has built a low-cost structure should be a lesson to almost any type of business. This structure allows the company to slash prices, gobble up market share, and grow rapidly, yet *remain highly profitable*. This is precisely the formula that the likes of Wal-Mart and **Dell** (Nasdaq: DELL) used to dominate their industries.

Whether JetBlue will be able to do the same is another question, and one I'll take up in a future column.

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JetBlue's Customer Experience

Whitney Tilson continues his series on JetBlue Airways by highlighting how the airline has taken dramatic steps to improve the flying experience of its customers.

By Whitney Tilson
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(http://www.fool.com/news/commentary/2003/commentary030725wt.htm)

If you're like me, you dread the thought of flying these days. With major airlines cutting back on routes and service, flying has gone from bad to worse and become one of the worst experiences American consumers must endure. (To read about my experiences flying four airlines this week, click here.)

JetBlue (Nasdaq: JBLU) is an exception, and because of this, will succeed in this otherwise dreadful industry. I don't own the stock (nor do I recommend it at today's nose-bleed levels), but I'm impressed enough with JetBlue to spend a few columns analyzing its model. *All* companies and investors can learn from what JetBlue is doing.

Key to JetBlue's model are low prices made possible by an exceptionally low cost structure (discussed in my last column). But that's just the beginning. In short, JetBlue has made great strides toward achieving what CEO David Neeleman calls "the very simple goal of bringing humanity back to air travel." Humanity. Notice Neeleman didn't say, "bringing low fares and good service back to air travel." He said, in effect, that most airlines treat their customers in an inhumane fashion and that he was determined that JetBlue would be "a different kind of airline."

So far, JetBlue is achieving his goal. Consider the following data for the full year 2002:

Metric	JetBlue	Majors' Avg.
Completion Factor	99.8%	98.7%
On-Time Performance (1)	85.7%	82.1%
Mishandled Bags (2)	2.3	3.8
Customer Complaints (3)	0.4	1.2
Passengers Denied Boarding (4)	0.0	0.7

Note: In 2002, JetBlue was not required to report these statistics to the U.S. Department of Transportation (DOT) so all JetBlue statistics are self-reported. Since then, JetBlue has voluntarily reported this data to the DOT. Data for the major airlines is from the DOT.
(1) Within 14 minutes
(2) Reports per 1,000 passengers
(3) Reports per 100,000 passengers
(4) Per 10,000 boardings

JetBlue's own surveys show that 94% of its customers ranked their JetBlue experience as "Much Better" (64%) or "Somewhat Better" (30%) than other airlines. while 99% said they "Definitely Would" (88%) or "Probably Would" (11%) recommend the airline to others. Normally, I'd be skeptical of an in-house survey, but my own experiences flying the airline more than 20 times convince me that JetBlue is indeed creating legions of fanatically loyal customers.

How is JetBlue doing this? Let's take a closer look at how JetBlue has addressed the complaints that really anger airline passengers today.

Indifferent service
Smiling, motivated, enthusiastic employees are critical to customer service in any industry. Stories I've heard, plus my own observations, lead me to believe that JetBlue has a significant advantage in this area, driven by its corporate culture. How JetBlue has built this culture and whether it is sustainable is the topic of my next column.

Dingy planes, uncomfortable seats and no legroom
Most jets in the major carriers' fleets are between five and 12 years old, and it's not uncommon to find 20- or even 30-year-old aircraft in service. In contrast, JetBlue's planes are brand spanking new and have extra-wide all-leather seats with bottoms that move for added comfort. The company just announced that it will take out an entire row of seats in every aircraft, thereby increasing the pitch on most seats from 32 to 34 inches, which makes a big difference for long-legged people like myself.

High prices, crazy pricing schemes, restrictions and fees
JetBlue charges considerably less than just about any other airline. (See my last column for further details.) But airlines are plagued by more than high fares -- pricing schemes are absurd and unfair. If you don't book long in advance, fly round-trip between the same two cities, and stay over a Saturday night, the prices are often obscene. And heaven forbid that your plans change and you get stuck a $100 penalty or, worse yet, you lose all of your money (I got this from **American Airlines** (NYSE: AMR) only two days ago).

All of JetBlue's flights are one way, so there's no ridiculous Saturday night-stay requirement, and you aren't penalized if you, for example, fly from New York to Long Beach, drive to San Diego, and then fly back from there. Nor are there standard advance-purchase requirements to get the best fares. Sure, JetBlue's prices tend to go up closer to the date of travel, as the planes fill, but the simple pricing model means no nasty surprises. And if you cancel or change a flight, the fee is a reasonable $25 and you can use the credit to buy a ticket for anyone, not just yourself.

Delays
JetBlue is fanatical about on-time departures and arrivals. JetBlue's performance has actually improved this year: in Q2, its completion rate rose to 99.9% and on-time performance was 87.4%. There are countless reasons why flights get delayed, many of which are out of the control of any airline, but JetBlue's performance is not an accident. Consider the following:

- Brand new planes tend to break down less frequently.

- JetBlue, like **Southwest** (NYSE: LUV), only flies one type of aircraft, so if something goes wrong it's easy to switch planes, spare parts, pilots, and flight crews.

- The hub-and-spoke system that most airlines uses invites delays. JetBlue flies only point-to-point.

- In the New York area, JetBlue chose to base itself at John F. Kennedy Airport (JFK) rather than LaGuardia or Newark for a number of reasons (e.g., lower costs, available gates) but also because it is less congested, both in the air and on the ground, and suffers from fewer weather delays.

- While other airlines will shut down when it gets too late at night, JetBlue has a different policy: According to Dave Barger, JetBlue's President and COO, "some days we get shut down entirely, but by and large, we'll operate late on a bad weather day even if it means we finish at 2:00 a.m. People appreciate the fact that they get there." JetBlue's policy also means that crews and planes aren't starting the next day at the wrong location, which prevents the ripple effect of problems from one day affecting the next day.

- JetBlue keeps a spare plane at each of its major East and West coast hubs, JFK and Long Beach. Other airlines use spare planes as well, but JetBlue's 22.5:1 ratio of active-vs.-spare planes is markedly better than the industry standard of approximately 50:1.

- JetBlue flies dozens of flights daily between New York and five Florida cities -- an Eastern seaboard route that is often closed due to congestion or thunderstorms. To improve the odds that its flights can operate on time, all JetBlue planes are equipped with life rafts and vests so they have the option of using flight paths over the Atlantic.

- Fast turnaround times at the gate, averaging 35 minutes vs. an hour or more at the major carriers, keeps JetBlue's planes on-time and in the air an industry-leading 13 hours per day.

Dealing with delays
Some levels of delays are inevitable, of course, but how an airline handles them can make a big difference in customer satisfaction. Too often, I feel that airlines are treating me like a mushroom: kept in the dark and fed manure. In contrast, my experience with JetBlue is that the airline and its employees go out of their way to give excellent service, empathize with passengers when things go wrong, and do their best to treat them well and, when the situation calls for it, compensate them.

Getting bumped
Most airlines overbook their flights, which means that, on occasion, passengers with a ticket can't get on. This policy infuriates customers and creates delays, as gate agents attempt to bribe passengers to give up their seats. And the problem is getting worse: *The Wall Street Journal* reported last week that "about 10,200 passengers on the 14 largest U.S. airlines were denied boarding during the first quarter of this year because plane seats were oversold, according to a Department of Transportation survey released earlier this month. That's up 16% from last year -- and the highest percentage of people involuntarily kicked off planes in three years." JetBlue does not overbook its flights -- hence the 0.0 figure above for "Passengers Denied Boarding."

Boredom
I actually look forward to long flights to catch up on my reading, but many people are bored (or desperate to entertain their children), so JetBlue's 24 channels of live TV is a huge plus. One airline executive I spoke with acknowledged "it's the biggest step forward in in-flight entertainment in 25 years." JetBlue was the first airline in the world to offer live TV and, to maintain this advantage as long as possible, actually bought the company that supplied it with the technology (which JetBlue has now licensed to **Frontier Airlines** (Nasdaq: FRNT) and Canada's **WestJet** (TSA: WJA)).

Long lines to check in
When you go to check in, have you ever watched the person behind the counter type all of that crazy gibberish into the computer? This process is slow and prone to error. In contrast, JetBlue uses the Open Skies software system, which means that agents can process a passenger without checked luggage in less than one minute.

Long lines to go through security
Am I the only person who thinks it's really silly to slow down the processing of passengers through a security checkpoint by randomly selecting people for an intensive security screening, or using a crude method such as checking whether a passenger has a one-way or round trip ticket? Neeleman is unabashed in stating that JetBlue uses profiling, however politically incorrect that might be, to target high-risk passengers for extra scrutiny.

Mishandled bags
JetBlue has a lower rate of mishandled bags than any major carrier. However, with the company carrying nearly 30,000 passengers per day, 2.3 mishandled bags per 1,000 (which rose to 3.4 in Q2) translates into roughly 70-100 unhappy customers daily. Barger described how JetBlue handles these "moments of truth" customer service situations:

"First of all, we don't only look at mishandled bags: for example, we want the first bag at the carousel within 10 minutes of arrival and the last one out within 20 minutes. What gets measured, gets managed. Our performance should be good because we don't have a hub and spoke system.

"When we do have a problem, we start right off the bat by giving the passenger a $25 voucher. It's empathy -- a gesture of goodwill. When you go into a traditional baggage service, you have to stand up at a podium and can't see computer. With us, customers can sit down at a desk, get a cup of free coffee, and see the screen. We try to get away from being baggage cops and give the customer the benefit of the doubt. It's a mindset -- we're in the service business."

No room in overhead compartments
With airlines removing so much capacity, flights are nearly always full these days, which means that there often isn't enough room in overhead compartments. The result is that late-arriving passengers are often clogging the aisle, looking for room for their bag (delaying departure), or are forced to check their bag, which means they have to sit around waiting at the baggage carousel upon arrival (one of my pet peeves). To minimize these problems, JetBlue's new planes have extra-large overhead bins.

Lousy food
Airline food hasn't been much to write home about for some time, but my perception is that it's getting worse. JetBlue gets around this potential problem in a simple way: it doesn't serve any meals -- only snacks and drinks -- even on its longest cross-country flights. Instead, JetBlue encourages passengers to buy food in the gate area (or bring it from home) and take it on the flight.

Customer satisfaction is less a function of reality, but rather the *gap* between expectations and reality. By removing any expectations for food, JetBlue's customers are, I suspect, *more* satisfied than passengers on other airlines who expect a meal and are then served a lousy one.

Conclusion
Consistently delivering an exceptionally positive customer experience is the key to long-term business success in *any* industry. Doing so, however, is extremely complex and difficult, yet once achieved, it

can feed on itself, creating a virtuous cycle, and become a powerful competitive advantage -- one that can be very difficult for competitors to match. JetBlue clearly understands this and the results show. Other companies should be looking to take a page from JetBlue's book.

[For more on the best ways to travel, visit The Motley Fool's Travel Center.]

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JetBlue’s Friendly Skies

Whitney Tilson continues his series on JetBlue Airways, focusing on how the airline built a culture that has translated into higher productivity, lower costs and better service.

By Whitney Tilson
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(http://www.fool.com/news/commentary/2003/commentary030808wt.htm)

In recent columns, I’ve discussed how **JetBlue’s** (Nasdaq: JBLU) low cost structure and outstanding customer service give it an edge over other carriers. At the root of both is JetBlue’s corporate culture, which, nurtured properly, could provide an enormous long-term competitive advantage.

Two years ago, I addressed this topic in “Corporate Culture Impacts Profits:”

> What is culture? The word has many definitions, but Merriam-Websters has the one I’m looking for: “The set of shared attitudes, values, goals, and practices that characterizes a company.”
>
> It’s easy to think of companies -- **Wal-Mart** (NYSE: WMT), **Home Depot** (NYSE: HD), **Starbucks** (Nasdaq: SBUX), and **Southwest Airlines** (NYSE: LUV) come to mind -- with strong cultures. At such firms, I find, employees care about the company, each other, and customers. They share information and cooperate. They feel good about their jobs and are willing to go the extra mile.

I can’t stress enough the importance of a strong culture in a tremendously labor- and service-intensive industry like the airlines. In the words of one long-time **United Airlines** (NYSE: UALAQ) pilot:

> People can focus on CASM, RASM, yield, stage length, turns, you name it. The real reason things are going well at JetBlue, at least looking at it from the other side of the fence, is the human relations and values of management. Why are Southwest and JetBlue profitable, when much of the rest of the industry is unprofitable? There are many factors, but among the most overlooked are their motivated, passionate workforces. By focusing energy on their employees, Southwest and JetBlue may have found the secret ingredient to airline success.

The dysfunctional airline industry
I’ve studied countless industries in my career and have never encountered such awful labor-management relations and dysfunctional cultures as we find in the airlines (though steel is a close second). Stanford Business School Professor Jeffrey Pfeffer agrees, noting in a 1994 article:

> In the United states, with few exceptions (Southwest and Delta being two), most airlines have followed practices with respect to their employees that are, for the most part, diametrically opposite of what would be required to achieve competitive advantage through people -- and this in a service industry.

One doesn’t have to look far to find examples. Rick Dubinsky, until recently head of United Airlines’ pilots’ union and board member of UAL Corp., once wrote to his fellow pilots: “The forces marshalling against you [e.g., management] are deadly and determined. They are cold, calculating, powerful, well-schooled, professional, patient, and they do have endurance." He also famously quipped of his negotiating philosophy: "We don't want to kill the golden goose. We just want to choke it by the neck until it gives us every last egg."

Problems are not unique to United. A long-time pilot for **Delta** (NYSE: DAL), long regarded among the major carriers for its relationships with employees, wrote recently in a letter to an Atlanta newspaper: "How befuddling that a corporation would spend money to hire a consulting firm to improve its image with its employees. Seems like just treating the employees in a fair and honest manner would have accomplished the same thing. The Delta pilot group consists of about 90% former military officers. Rule one for an officer is that you take care of your troops before you take care of yourself."

And what did **American Airlines** (NYSE: AMR) do in April? At a time when the airline was hemorrhaging cash, CEO Don Carty called for "shared sacrifices" to avoid bankruptcy. Yet only days after the unions narrowly voted to accept $1.62 billion in annual concessions, they discovered that management had just paid itself large executive retention bonuses and pension protections. This unbelievable burst of insanity cost Carty his job and speaks to the "let's-look-out-for-ourselves-and-to-hell-with-the-employees" attitude that pervades the industry.

A good company

On a cross-country flight earlier this year, I had a long talk with a JetBlue flight attendant who used to work for United. She told me that while her base pay is lower, she makes it up by working overtime and participating in the stock purchase plan. She likes working for JetBlue because the company treats her well, she is already quite senior (meaning that she has her pick of routes), and her fellow flight attendants work as hard as she does.

By contrast, at United, she said relations with management were terrible, and she was often frustrated by burnt-out, unmotivated colleagues who -- knowing that their union would protect them -- were rude to passengers or simply sat at the back of the plane during the bulk of the flight. I also interviewed a JetBlue telephone reservations agent when I booked a flight a few weeks ago. She had been with JetBlue for a year and said "I enjoy working for them very much. The people are very nice. It's a good company with good benefits."

Cultural differences

When it comes to building and nurturing a strong corporate culture, there is no magic bullet -- rather, it depends on doing dozens of little things right every day. Here are the keys to JetBlue's success:

- Culture begins with a set of values. Early on in the planning process, 20 members of JetBlue management met for two days and settled on five core values: safety, caring, integrity, fun, and passion. Today, JetBlue's web site notes, "These five values not only differentiate JetBlue's product; they result in a superior customer and crew member experience."
- Leadership at the top is critical, and JetBlue's CEO David Neeleman is a master motivator. He takes every opportunity to acknowledge and thank his employees, reinforcing his words in the latest annual report: "At JetBlue, we operate under the belief that great People drive solid operating Performance which yields continued Prosperity. Our People are the foundation on which our success is built." Another time, he noted, "We didn't build our company on the backs of our people, and we never will. We will always put our people first, before our customers and our shareholders."

- The rest of JetBlue management is on the same page. For example, President Dave Barger, who worked for **Continental** [(NYSE: CAL)] and New York Air and whose father was a United pilot, notes, “In this business you look at the landscape of shrapnel that’s out there between labor and management, and if you can’t learn from that, you’re brain dead.”
- Neeleman and Barger attend most new employee orientation sessions, fly the airline frequently, help load baggage, take tickets, and so forth. Sure, much of this is public relations, but image matters.
- JetBlue hires very carefully. With so many major carriers laying off tens of thousands of employees, JetBlue has the luxury of being extremely selective.

JetBlue is no doubt benefiting from the excitement and *esprit de corps* associated with a new, rapidly growing company. It will be a tremendous challenge to maintain this strong culture as JetBlue ages. Still, management provides the right incentives: JetBlue contributes 15% of its pre-tax income to a profit-sharing plan, which last year translated into a 15.5% bonus for all employees. In addition, there’s a generous stock purchase plan, with nearly 70% participation overall, plus new pilots get 6,000 stock options.

Bringing it on home

Thinking about corporate culture might sound “touchy feely,” but I would argue that few factors are more important to a company’s -- and its stock’s -- success. This is especially true in the airline industry, where a long-time pilot assures me:

> Network airlines like United and American have lost sight of the people behind the numbers. In a service industry, motivated employees can help generate a profit, while unmotivated employees can contribute to a loss.
>
> In need of impassioned leadership to overcome an epidemic of low employee morale, too many major airlines focus on self-preservation rather than solid corporate vision. So long as they continue to do so, with each cultural misstep, Southwest, JetBlue, and others will gain market share, one dissatisfied customer at a time.

Whitney Tilson is a longtime guest columnist for The Motley Fool. He did not own shares of the companies mentioned in this article at press time, though positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. The Motley Fool is investors writing for investors.

JetBlue's Challenges

Whitney Tilson admires upstart airline JetBlue, but does not recommend its stock because of its rich valuation and the many challenges the company faces as it matures.

By Whitney Tilson
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In the four columns I've written about JetBlue Airways (Nasdaq: JBLU) over the past three months, I've expressed tremendous admiration for the airline -- in particular, its cost structure, customer service, and culture -- and concluded in my initial column that JetBlue "has a decent chance to become the **Wal-Mart** (NYSE: WMT) of the airline industry over time."

That being said, this upstart airline operates in what remains one of the worst industries imaginable and faces significant challenges, factors that I'm not sure investors are considering fully given the nose-bleed valuation they are assigning to the stock (at yesterday's close of $59.13, it trades at 44.5x this year's consensus analysts' estimates of $1.33 and 32.2x next year's estimates of $1.73).

While I did not recommend the stock three months ago at $39.71, I did pay it a great compliment by saying, "If I were forced to buy one stock trading in excess of 35 times this year's estimates, it would be JetBlue." I can no longer say this today, given the substantial run-up in the stock since then and my greater appreciation for the many challenges JetBlue faces. Let's talk about a few of them, keeping in mind that after extolling the company's many virtues for four columns, I'm going to give skeptics a full hearing.

Maintaining the culture
As I noted in JetBlue's Beautiful Cost Structure, the company's success is rooted in two areas: highly productive people and highly productive aircraft. Regarding the former, with the exception of **Berkshire Hathaway** (NYSE: BRK.A), I have never in my studies of thousands of businesses seen such universally motivated, hard-working employees (called crewmembers) as I have at JetBlue -- and this in an industry infamous for having horrific labor-management relations.

I attended a new employee orientation session last week, at which both CEO David Neeleman and President Dave Barger spoke (as they do at nearly every such event), and the enthusiasm in the room was palpable. This benefits the company in so many ways, including lower costs and exceptional customer service. I wish I had the space in this column to tell you the remarkable story of teamwork and commitment that enabled JetBlue to continue flying nearly its full schedule through the recent blackout in New York -- the only airline to do so.

JetBlue's senior managers, without exception, agree with me that maintaining such a strong culture is the single biggest challenge facing the airline. It can be done -- witness **Southwest Airlines** (NYSE: LUV) over the past three decades -- but my experience is that most companies lose this magic as they grow. The fact that airline unions (rightly) view JetBlue as a tremendous threat only adds to the challenge. One airline CEO told me that "JetBlue is ALPA's (the militant and powerful Air Line Pilots Association) worst nightmare, and they will do anything to unionize JetBlue." (He added that, if JetBlue continues treating its crewmembers well, he thought it could possibly fend off ALPA and the other unions, though it might have to boost pay rates to do so.)

Pay rates
Generally speaking, JetBlue's overall pay scale is somewhat lower than that of major carriers -- it's roughly in line with discount airlines -- but JetBlue attracts and motivates talented crewmembers in a number of ways, including developing a well-deserved reputation for treating crewmembers well and having a great work environment, offering the opportunity for rapid advancement (for example, a First Officer can be promoted to Captain in less than three years), scheduling efficiently (thereby minimizing unpaid downtime), and contributing 15% of profits to a crewmember profit sharing plan.

Key motivators also include stock options and especially the generous employee stock purchase plan -- both of which are linked to JetBlue's soaring share price. My concern is what happens if the stock is flat for many years or, worse yet, tumbles -- both of which could easily happen, given its current levels. While this would not affect many of the factors discussed above that contribute to high morale, crewmember enthusiasm could wane, demands for higher pay could emerge, and odds of unionization could rise -- all of which would substantially erode JetBlue's cost advantage.

Maintenance
Airplanes are very expensive to maintain and, unlike many other cost areas, there is little room for one carrier to gain a cost advantage over another, assuming variables such as type and age of aircraft, stage length, etc. are held constant. Yet JetBlue's maintenance costs are dramatically lower than even other low-cost carriers, primarily because its planes are brand new.

As of the end of 2002, the average age of JetBlue's planes was a mere 15.5 months. For comparison, on the same date Continental's (NYSE: CAL) 366 mainline jets were seven years old on average -- and this is one of the youngest fleets among the major carriers. So many new planes give JetBlue an enormous cost advantage in its first few years, but this advantage is certain to diminish over time as JetBlue's aircraft and engines reach the age at which they require multi-million dollar overhauls.

As the fleet ages, the question becomes just how much and how quickly this cost advantage will diminish for JetBlue. It's not easily answered. JetBlue estimates that maintenance costs will only rise moderately by 0.2-0.3 cents per available seat per mile (ASM) over the next five years. I tend to believe that estimate, assuming JetBlue maintains its aggressive delivery schedule of new aircraft, though it's disputed by one executive of an airline that operates A320s: "I don't think [their estimate] is consistent with their fleet plan -- I think it's underestimated."

Another executive told me, "The downside of taking so many new aircraft in such a short period of time is that all of these planes and engines will need major overhauls at the same time. Just watch what happens to their stock when they unexpectedly report $20 million in maintenance costs one quarter."

This is indeed a danger, but I'm not convinced that it will play out this way. JetBlue may be able to offset higher maintenance costs with efficiencies in other areas (overall economies of scale, lower landing fees, and reduced financing costs, for example) or the ability to charge higher prices over time due to success building the brand, generating customer loyalty and/or achieving dominance in certain markets -- but investors should keep in mind that these factors are uncertain, while significantly higher maintenance costs are 100% certain.

Finding attractive markets
Like any airline, JetBlue evaluates every possible route that it might fly based on many factors, including current and potential traffic, existing price levels, strength of competitors and their likely

reaction to encroachment, etc. I think it's reasonable to assume that as a general rule JetBlue chooses to serve the most attractive routes first, which explains why most flights today are in the heavily traveled New York-Florida and New York-West Coast routes.

But consider what happens as JetBlue grows: It must go further and further down its list of attractive routes, which is likely to pressure growth and margins. As one airline executive commented to me, "If Oakland-Atlanta is the best they could do for a new route, what on earth are they going to do with all of the new planes being delivered in the near future? And Southwest already owns 70 of the top 100 markets."

JetBlue strongly disagrees that there is any shortage of attractive routes to expand into, and cites data showing hundreds of routes with decent levels of traffic, in spite of current high fares. By introducing low fares and exceptional service, JetBlue believes it can stimulate demand as it did in the New York-Buffalo market, which has grown from 500 to 1,400 passengers per day each way since JetBlue started flying that route. If JetBlue can indeed grow the new markets it targets by such a degree, its growth plans will likely pay off -- but that's a big if.

Competitive reaction
While JetBlue has faced significant competition to date, the competitive environment is likely to provide an even stiffer headwind in the future for three reasons. First, as recently as this spring nearly every major airline was facing severe financial distress, yet almost all are in significantly better (though still precarious) shape today because they refinanced debt, raised additional capital and so forth (just look at the stock charts -- the airline sector is one of the top performers this year). While one could argue that healthier competitors might lead to more rational pricing, it can't be good news for JetBlue when its competitors significantly enhance their financial strength.

Second, to continue its torrid growth, JetBlue will increasingly have to start flying routes -- generally into competitors' hubs -- that will trigger violent reactions. One executive at a competing carrier told me, "JetBlue has been successful so far by flying fragmented markets [thereby avoiding all-out retaliation], but this will not be true going forward."

As evidence of this, consider the Long Beach-Atlanta route: When JetBlue launched three flights a day, Delta and **AirTran** (NYSE: AAI) responded by slashing prices and flooding the market with extra flights, which CEO David Neeleman said bordered on "predatory behavior." This was one of the reasons JetBlue pulled back to only one flight a day in this market and instead increased frequency on the Oakland-Atlanta route.

Finally, JetBlue's success is sure to attract new upstart competitors that may have even newer planes and lower maintenance costs. In fact, Richard Branson's Virgin Group, which has successfully built low-cost carriers in Europe and Australia, recently announced that it plans to launch a well-capitalized U.S. airline "definitely within nine months."

Managing hypergrowth and a new type of aircraft
JetBlue's success to date can be attributed in large part to wisely copying much of the model that has made Southwest the shining star of the airline industry for more than three decades: treating employees well, offering only point-to-point service, flying only one type of aircraft, etc. But JetBlue is deviating from this model in two related and important ways: Rather than being content to grow at a 10-15% rate each year, as Southwest has been historically, JetBlue has pursued hypergrowth, leaving little margin

for error (last quarter, revenues grew 64% and the company plans to take delivery of 21 new aircraft by the end of next year, growing its fleet 45% from 47 to 68 planes).

To continue high growth, JetBlue recently announced that it has placed firm orders for 100 new Embraer 190 aircraft, with options for 100 more. I've seen mock-ups of this plane, which seats 100 passengers (vs. 156 in the A320), and I'm impressed. However, adding a second type of aircraft adds significant complexity, and committing to so much additional growth is risky. One airline executive told me that he has carefully analyzed point-to-point routes for smaller markets and, even assuming a cost structure as low as JetBlue's, concluded: "There are only a small handful of markets that can support 90- or 100-seat jets, so I have no idea where JetBlue thinks they can put so many planes."

Conclusion

I believe that sensible, prudent investors should spend the bulk of their time thinking about what can go wrong, especially when analyzing a richly valued growth stock like JetBlue, so let's consider the following doomsday scenario, outlined to me by a long-time executive in the industry:

"Everybody seems to believe that JetBlue has reinvented the wheel, but the fact is that they haven't. I worked for [an upstart airline] years ago and our stock rose more than *ten times* over a few years as we grew quickly and reported high margins, due primarily to the low maintenance costs associated with new aircraft. But then we ran out of new, attractive markets to penetrate, growth slowed, maintenance costs soared and our stock collapsed. I've seen situations like this many times before: As planes and employees get older, things change -- and what's amazing is how rapidly things change in this industry."

Will JetBlue follow the same Icarus-like path of so many of its predecessors? I don't know, but I'm certain that to avoid this fate, JetBlue will have to create a powerful brand that will translate into customer loyalty and a willingness to pay more for JetBlue's product. I don't believe that any airline has truly been able to break away from the commodity-like nature of this industry, but I applaud JetBlue's audacious attempt to do so. And it just might succeed if it can replicate its success in the New York-Florida market, in which JetBlue has the greatest number of flights and highest load factor, despite charging *higher* prices *and* flying from a less convenient airport.

As an admirer of JetBlue -- and a New York City resident who benefits from its presence in the market -- I hope the company is successful, but I'm not even tempted by the stock at these levels. As with any richly valued stock that is widely beloved by investors, I suggest searching for stocks at the other end of the investment spectrum.

Whitney Tilson is a longtime guest columnist for The Motley Fool. He owned shares of Berkshire Hathaway at press time, though positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. The Motley Fool is investors writing for investors.