MERRILL LYNCH, PIERCE, FENNER & BEANE
UNDERWRITERS AND DISTRIBUTORS OF INVESTMENT SECURITIES
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American Airlines

FROM
E. F. HALSELL
MERRILL LYNCH, PIERCE, FENNER & BEANE
601 Fort Worth Club Building
Phone FOrtune 7131
Fort Worth 2, Texas

JULY 26, 1954

A LONG RANGE APPRAISAL OF THE AIR TRANSPORTATION INDUSTRY

MARKET CONCLUSIONS: At the outset let us state that we regard all airline securities as speculative, but that their longer-range prospects shape up favorably looking a year or so ahead. In the meantime, this volatile group of stocks may be subject to occasional weak spells, but we would regard such periods as buying opportunities rather than as reasons for concern about the group's longer-range outlook. Against this background, we believe that Eastern Airlines and Delta-C&S combine the relatively smallest measure of market risk with the best combination of potentially favorable elements. Both companies have demonstrated their operational efficiency, are financially sound and should depend relatively little on air mail revenue in the future. Also, they have a minimum of equipment and route problems. Delta has had its difficulties in integrating its operations with those of Chicago & Southern, but a solution of that task is now in sight.

Next in line, we place American Airlines, National Airlines, Pan American World Airways and United Airlines.

Where speculation centers on maximum capital gain possibilities, Northwest (including the convertible preferred stock) and TWA would seem to offer the greatest potentials, but one must be fully aware of the fact that the realization of these potentials depends importantly on the favorable outcome of a number of problems confronting both companies.

Of the remaining companies, Capital is in the best leverage position, but the growth potential of its present route system is deemed to be relatively limited. The same holds true for Braniff, Continental and Western Air Lines. Colonial and Northeast are essentially speculations on eventual mergers.

RECENT DEVELOPMENTS

In the case of most airlines, operating results for the first half of 1954 will compare unfavorably with the first six months of 1953. From a profit point of view 1953 was a satisfactory year, but the generally good results were chiefly due to the industry's strong performance during the first half of the year. While traffic volume increased fairly steadily throughout the year, the introduction of new equipment, coupled with increased flight scheduling, added to available seats at a rate in excess of traffic gains. This resulted in lower load factors which, together with a continued rise in operating costs (including higher depreciation requirements), made monthly profit comparisons gradually less favorable beginning around July-August of last year. The load factor decline, of course, was not entirely peculiar to 1953, as it had been in evidence for a couple of years. However, it was particularly disappointing as it came at a time when all indications pointed to a year of highly profitable operations.

The following table shows the extent to which the "carrying capacity" of representative company fleets has been enlarged in recent years, the extent to which traffic volume has grown and the extent to which capacity has been utilized:

Year	Available (Capacity) Ton Miles (Millions)			Revenue Ton Miles Flown (Millions)			Percent Available (Capacity) Ton Miles Utilized		
	1953	1952	1951	1953	1952	1951	1953	1952	1951
American	654.0	536.2	451.1	403.4	358.0	308.5	61.7%	66.8%	68.4%
Eastern	546.0	466.0	358.4	279.6	225.7	184.8	51.2	48.4	51.6
TWA	510.9	405.4	350.2	335.6	274.4	244.0	65.7	67.7	69.7
United	579.7	494.3	369.4	321.0	290.8	231.7	55.4	58.8	65.3
Pan American	447.0	409.5	348.8	277.5	256.7	230.4	62.1	62.7	66.1

INDUSTRY OUTLOOK

NEARER TERM: Ton mile capacity will continue to rise for the balance of this year and, in some instances, well into next year as additional equipment, still on order, comes in. The extent to which the profitability of operations of individual companies will be affected should vary with the amount of equipment still to be received. In other words, those companies approaching the end of equipment deliveries are likely to report a relatively better development of load factors and, probably, a somewhat better development of earnings, comparatively speaking. Over the months more immediately ahead, the effect of further additions to seat capacity will be mitigated by the seasonally heavy traffic, but in the coming winter months, a reoccurrence of low load factors, and presumably, of temporarily unprofitable operations is indicated, particularly for those carriers still taking in new equipment between now and next spring. United Airlines, with heavy deliveries of DC-7s this year will add most to capacity (though some old equipment may be sold) during the balance of 1954, while TWA, recipient of new "super" Connies, is likely to lead in 1955.

LONGER TERM: Looking into and beyond 1955, there are strong reasons to support the opinion that airline operations stand a good chance of becoming appreciably more profitable for a period of several years. The principal reasons for these conclusions follow:

1. Both passenger and freight traffic are expected to show steady growth, the former at an estimated rate of from 8% to 12% annually.

2. Load factors should improve. With two or three exceptions, domestic trunk airlines now operate mostly the latest Convair, Douglas, Lockheed and Martin commercial planes. Wholesale fleet replacements such as seen during 1946-52 (and which contributed to the violent fluctuations in the profitability of airline operations) are unlikely to recur until the advent of commercial jets. That event is now estimated to occur no earlier than 1959 or 1960. Thus, traffic volume should have a chance to catch up on seat capacity.

3. Pressures in Congress and in some quarters of the Administration against continuing to underwrite (through subsidy payments) unprofitable airline operations point to the probability of (1) some eventual airline mergers; (2) stricter regulations of non-certificated (unscheduled) airlines which still attract important passenger volume. Developments in either direction would be constructive to the larger carriers.

4. Possibility, admittedly somewhat remote at this point, that some sort of fair adjustment may be permitted by the CAB. Most likely this will take the form of reductions in round-trip discounts, family plan concessions, etc., or rounding up fares to the nearest dollar, rather than through any general fare increase.

In the case of Eastern and American, and to a lesser degree in the case of Western, earnings will benefit, a year or two from now, from lower depreciation requirements. The following table shows the relative importance of depreciation requirements over the next few years.

ESTIMATED DEPRECIATION REQUIREMENTS OF PRINCIPAL AIRLINES

(Based on rates used for Stockholders' Reports)

	Million Dollars					Dollars Per Share				
	1954	1955	1956	1957	1958	1954	1955	1956	1957	1958
American	$22.0	$19.0	$16.0	$16.0	$14.0	$ 3.40	$ 2.90	$ 2.50	$ 2.50	$ 2.20
Braniff	3.5	(a)	(a)	(a)	(a)	2.70	(a)	(a)	(a)	(a)
Capital	2.0	(a)	(a)	(a)	(a)	2.50	(a)	(a)	(a)	(a)
Continental	1.1	1.3	1.3	1.3	1.2	2.80	3.30	3.30	3.30	3.00
Delta (b)	5.3	5.6	5.4	5.0	5.0	8.80	9.30	9.00	8.30	8.30
Eastern	24.5	28.0	19.5	15.0	9.0	9.80	11.00	7.80	6.00	3.60
National (b)	3.5	4.3	4.3	4.2	3.7	3.50	4.30	4.30	4.20	3.70
Northwest	5.5	(a)	(a)	(a)	(a)	6.70	(a)	(a)	(a)	(a)
Pan American	18.0	21.0	23.0	(c)	(c)	2.90	3.40	3.80	(c)	(c)
TWA	20.7	24.1	25.3	23.8	20.0	6.20	7.30	7.60	7.10	6.00
United	28.0	33.0	35.0	35.0	28.0	11.20	13.20	14.00	14.00	11.20
Western	1.8	2.2	1.8	1.8	1.8	2.50	3.10	2.50	2.50	2.50

(a) - Estimates impracticable at this point. In case of Braniff, sale of Latin American route would bring about a change in company's equipment position. In case of Capital and Northwest, important decisions regarding equipment modernization are pending.

(b) - For fiscal years ending June 30th.

(c) - Available information does not permit of estimates beyond 1956.

IMPORTANT NOTE: Above estimates are based on equipment currently in use, equipment under contract for future delivery, and depreciation rates currently used by companies concerned. Estimated requirements could be altered by changes in depreciation policies, purchase of equipment in excess of outstanding orders, or sale of equipment not fully amortized.

Of course, the general industry background is not devoid of some unfavorable features, though, in the long run, these should be outweighed by the favorable developments outlined above. The unfavorable factors may be summarized as follows:

1. Operating costs are still rising and will undoubtedly continue to rise further.

2. Equipment profits, which supported the net profit picture of quite a few companies during recent periods of unprofitable operations will be considerably less of a factor in the future since open market prices for used equipment such as DC-3s and DC-4s have dropped sharply.

3. Congressional pressures for budgetary economy, together with insistence by the Post Office on transporting mail the cheapest possible way, is apt to result in lowering mail and/or subsidy revenue to some carriers. Fortunately this source of income has become less important to airlines. In many cases, it contributes but a small portion of gross revenue, but as shown below it still is a most important item in terms of operating profits in the case of most companies.

	U. S. Airmail and/or Subsidy Revenue as Percent of			
	Gross Revenue		Operating Profit	
	1953	1952	1953	1952
	(Based on CAB Reports)			
American	3.8%	4.2%	29%	29%
Brannif	8.0	9.3	(1)	(1)
Capital	2.8	2.5	41	50
Continental	10.2	11.0	232	145
Delta	4.7	7.4	119 (2)	55
Eastern	2.1	2.2	18	17
National	2.5	2.4	22	22
Northwest	11.1	12.4	219	450
Pan American	17.8	18.9	261	790
TWA	5.1	5.5	89	59
United	5.4	6.4	49	41
Western	3.8	3.9	34	24

(1) - Had operating loss of $804,000 before $3,160,000 of U. S. mail pay in 1953; broke even on operations with $1,300,000 of U. S. mail pay in 1952.

(2) - High ratio essentially due to integration with Chicago & Southern which resulted in sharp decline of operating profit, a temporary development, in our opinion.

NOTE: In appraising the importance of the above percentage figures, it should be realized that there is virtually no subsidy contained in the domestic operations of all but three or four of the smaller domestic airlines (Braniff, Colonial, Continental and Northeast). The other companies carry mail at what the CAB has designated as "service rates." However, there is no assurance that such "service rates" will not be reduced further, sometime in the future, and it is primarily for the purpose of showing the degree of vulnerability of the individual companies that the above table is presented.

WHAT GOVERNS AIRLINE STOCK SELECTION?

Under the longer-range prospects outlined above, the stock which should benefit most from rising traffic would be the one backed by the greatest number of revenue ton miles per dollar market value of stock combined with the lowest operating profit per revenue ton mile. Expressed in different terms this means, in theory at least, that (1) the greater revenue ton miles are per dollar market value of common stock, the greater is the leverage; (2) the lower the operating profit per revenue ton mile is, the lower is indicated operating efficiency and, consequently, the greater the margin for operational improvement. In practice, however, the varying characteristics and potentials of the different route systems prevent equally efficient exploitation, quite aside from the fact that some managements possess more administrative ability than others. Nevertheless, it is reasonably certain to assume that:

1. low operating profits per revenue ton mile generally go with low load factors;

2. where relatively high load factors produce relatively low operating profits, possibilities for more efficient operations are likely to exist (Delta-C&S is a typical case in point. There the problems of integrating two merged companies are only now approaching solution. Meanwhile, higher costs seriously affected profitability of operations, but a change for the better has been making its appearance in the last two months);

CAPITAL AIRLINES: Efficient management operating route system characterized by limited "long haul" traffic potential. Favorable CAB decisions in certain pending route cases could benefit Capital appreciably. Financial position not too strong with equipment modernization an important "must." Recent decision to buy British-built "Viscounts," a plane proven in operations abroad, would seem to contain (1) considerable element of speculation as to passengers' acceptance, maintenance, delivery and introduction problems and (2) questions involving financing, including rising depreciation charges in period when other companies may show declining requirements.

Recent Price: 10 1/2 Annual Dividend: Nil Yield: Nil

COLONIAL AIRLINES: Route system's profitability depends very heavily on subsidy revenue. More modern equipment needed. Company a definite merger candidate, with Eastern and National the two prominent contenders. Eastern's position would seem to have been weakened somewhat by recent CAB statement finding merger with National "in public interest."

Recent Price: 11 3/4 Annual Dividend: Nil Yield: Nil

CONTINENTAL AIR LINES: General company background relatively free of nearer-term problems, but route system's traffic growth potential somewhat limited. Profitability of operations dependent on air mail and subsidy revenue. Continental only airline to increase fares this year, probably because routes not subject to competition as intense as those of other carriers. Early merger with Pioneer, a feeder line, a good prospect; at later date merger with Braniff not impossible.

Recent Price: 7 1/2 Annual Dividend: $0.50 Yield: 6.7%

DELTA-C&S: Good routes, demonstrated operating efficiency. Delta's merger with Chicago & Southern last year caused severe route, equipment and personnel integration problems during much of 1953 and good part of 1954. End now in sight. Finances in fair condition. Importance of air mail revenue diminishing. One of the more liberal dividend payers. (Stock Comment No. 243 - July 16, 1954.)

Recent Price: 25 Annual Dividend: $1.20 Yield: 4.8%

EASTERN AIR LINES: General Background largely free of other than general industry problems. Efficient, conservative management. Finances strong. Equipment modern. Excellent record of past operating and profit performance. Recent attempt to merge with Colonial unsuccessful; odds seem against merger materializing at later date. Mail revenue small in relation to gross. Sharp decline in depreciation charges indicated later part 1955. (Stock Comment No. 126 - April 13, 1954.)

Recent Price: 27 Annual Dividend: $0.50 Yield: 1.9%

NATIONAL AIRLINES: Aggressive management, modern fleet. Good operating record. Fine routes but subject to intensive competition. Could possibly end up with Colonial. Financial position fair. Mail revenue not important.

Recent Price: 15 1/2 Annual Dividend: $0.60 Yield: 3.9%

NORTHEAST AIRLINES: Profitability of this strictly regional route system heavily dependent on subsidy revenue. Company a logical candidate for eventual merger.

Recent Price: 4 3/4 Annual Dividend: Nil Yield: Nil

NORTHWEST ORIENT AIRLINES: Routes have considerable traffic potential both domestic and international. Pending CAB decisions in connection with domestic route applications and foreign route certificate renewals could add appreciably to domestic potential, lessening the relative

importance of foreign operations. Mail and subsidy revenue important to profitability of combined domestic and foreign operations. Supreme Court recently ruled that subsidy requirements must be based on profitability of over-all operations rather than upon requirements of individual operating divisions. Congressional action establishing individual treatment for each separate operating division (domestic and overseas) would benefit Northwest, but early legislation in this direction is not indicated. Company faced with important decisions on new equipment purchases and filling of top executive spot.

Recent Price:	Common - 11	Annual Dividend:	Nil	Yield: Nil
	Convertible Preferred - 19 3/4	Dividend Arrears:	$0.86 1/4	

PAN AMERICAN WORLD AIRWAYS: Air mail and subsidy revenue loom large in gross and net revenue picture. Company's world-wide operations meeting with keen competition by domestic and foreign carriers, but increasing operational efficiency, modern planes and better fleet integration producing improving results. Important CAB route decisions pending in connection with future trans-Pacific operations. Profit prospects very importantly tied up with future basis of subsidy calculation, i.e., whether needs of company's four operating divisions should be determined individually (as hitherto done by CAB) or should the subsidy total be governed by profit ability of over-all operation. Congressional action may be necessary to determine future basis due to recent Supreme Court ruling holding over-all operation to be the determinant under present law. (Stock Comment No. 192 - June 4, 1954.)

Recent Price: 13 3/4 Annual Dividend: $0.80 Yield: 5.8%

TRANS WORLD AIRLINES: Excellent route system, both domestic and international. Mail and subsidy revenue important to profitability of over-all operation. Determination of future subsidy requirements subject to same factors as outlined for Northwest and Pan American above. International operation contributed a little under one-third to gross revenue last year. Important equipment deliveries scheduled for 1955, with depreciation requirements expected to remain relatively high for several years. (New Stock Comment in preparation.)

Recent Price: 17 1/2 Annual Dividend: Nil Yield: Nil

UNITED AIRLINES: Excellent transcontinental route system. Record of efficient operations. One of more liberal dividend payers among airlines. Well-integrated fleet, but substantial addition to capacity scheduled for delivery during balance of 1954. Consequently, depreciation requirements will remain relatively high for next 4-5 years. (New Stock Comment in preparation.)

Recent Price: 24 3/4 Annual Dividend: $1.50 Yield: 6.1%

WESTERN AIR LINES: Growth potential of company's traffic volume seems less well-defined than of some other domestic systems. Good management, fair financial condition. Air mail revenue of relatively modest importance only. Background free of special problems uncommon to general industry.

Recent Price: 10 1/2 Annual Dividend: $0.60 Yield: 5.7%.

SECURITIES RESEARCH DIVISION