060873

THE WALL STREET JOURNAL MONDAY, APRIL 16, 2001

DOW JONES VO 4/16

Headwinds

The Odds Are Against Starting an Airline— And Still They Try

With Tenacity and Little Else, These Two Men Took On Majors' Entrenched System

Getting Past 'the Sniff Test'

By BERNARD WYSOCKI JR.
Staff Reporter of THE WALL STREET JOURNAL

TULSA, Okla.—When James Swartz and John Knight headed to a resort in Puerto Rico to attend an aviation conference in January, they had a problem. Their start-up airline, Great Plains Airlines Inc., didn't have a single airplane.

At the conference, they figured, they could work the crowd of industry heavyweights and perhaps make a deal. Late one evening, Mr. Swartz bumped into a senior executive from Empresa Brasileira de Aeronautica, maker of the perfect plane for Great Plains' purposes: the 50-seat Embraer regional jet.

Mr. Swartz applied the soft sell. Great Plains had just put together $30 million in financing, he told the executive. And, he said, Great Plains' plan to take on the major carriers by bypassing their "hubs" and flying directly between Tulsa and the coasts might be something other airlines would emulate—translating into more sales for the Brazilian company. The next day, Mr. Knight took over, pressing his airline's case while spending the day snorkeling with the Brazilian executive.

As he left the convention, Mr. Swartz ran into an entrepreneur looking to set up an aircraft-manufacturing company. "You're the only person here who is crazier than I am," Mr. Swartz told the man.

More than three months of negotiations later, Messrs. Swartz and Knight still don't have an agreement with Embraer, but they are hopeful of taking delivery of some of the jets by the end of September. "It's complicated by the fact that we are a start-up," Mr. Swartz says.

In the meantime, the two men did get their hands on a couple of smaller aircraft by buying tiny, money-losing Ozark Air Lines of Columbia, Mo. But these planes can't make the trips to the coast that Great Plains is banking its future on.

It's an incremental advance typical of the gargantuan task of setting up an airline, an undertaking that would cow all but the most persistent—or foolhardy—entrepreneurs. More than 130 airlines have filed for bankruptcy since deregulation of the industry in 1978. And as the losers have piled up, the survivors have swollen into behemoths that dominate routes to and from their respective hub airports, creating little incentive for new entrants.

All round, the barriers to starting an airline are high. Great Plains wants to lease a few of the 50-seat Embraer jets, but without an established track record, it faces the difficulty of getting the specialized financing it needs. Even if it does find the financing, it still needs permission to land at some of the already-congested and tightly controlled airports it wants to serve from Oklahoma; without that permission, Great Plains could end up leasing jets that sit unused.


James Swartz

Another big obstacle: the industry itself. By proposing to fly directly to the East and West Coasts, Great Plains is hoping to answer the rising chorus of complaints from fliers tired of making one or more time-consuming connections. In fact, the airline has been financed largely by Oklahomans fed up with lousy service. Based on the demand they estimate for nonstop flights to coastal cities, Messrs. Swartz and Knight are predicting $144 million of revenue by the third year of operation.

But their plan takes dead aim at the complex system the major carriers have been constructing to their own advantage for 20 years. With the airlines' hubs and spokes, anyone who wants to fly between Oklahoma and New York City or Washington, D.C., must fly first to a hub at Dallas, St. Louis, Atlanta, or Chicago—a market that today encompasses several hundred fliers daily. Flying direct to coastal destinations risks inviting retaliation from the giant carriers who dominate the regional hubs: Delta Air Lines, TWA, United Airlines and especially AMR Corp.'s American Airlines, which already has managed to dent Great Plains' plans.

With so much working against Great Plains, the biggest thing working in its favor is probably tenacity. "If you dig long enough, you can dig a hole through the Great Wall of China," Mr. Knight says.

The 55-year-old executive vice president of Great Plains and Mr. Swartz, the airline's 52-year-old chief executive officer, are living proof that entrepreneurial spirit—the urge to create something new that challenges the established order of business—is alive and well. Even today, with the U.S. economy teetering on the edge of recession, a certain kind of personality still thrives on the prospect of succeeding where success, to others, seems like a pipe dream.

Messrs. Knight and Swartz are no tyros to the trade. As a young man in the military, Mr. Swartz, a native of Baltimore, learned to fly both helicopters and fixed-wing air-

Please Turn to Page A8, Column 1

Continued From First Page

craft. He got a law degree, co-founded a bank, and operated small newspapers and radio stations before taking jobs with several airlines. He then started an airline and sold it. Mr. Knight, also a trained pilot, was a lawyer at Boeing Co. and then a corporate executive in Pittsburgh, where he began dabbling in airline investments.

The two men first teamed up in the mid-1990s, planning to acquire or start an airline. They founded Jet Arizona, an air ambulance service where Mr. Swartz doubled as one of the pilots. The company, which turned profitable within a year of starting service, is still in their hands.

The two men were in Wichita, Kan., laying the groundwork for starting an airline there when Tulsa came calling. The city in the northeastern corner of Oklahoma is a classic second-tier city, and for years, the locals have been unhappy with their air service, usually having to make at least one connection to get to cities on the coasts. Finally, Tulsa Chamber of Commerce activists took action. Hearing about Messrs. Swartz and Knight, the city's leading lights in the fall of 1997 persuaded them to focus on Tulsa instead. As Mr. Knight recalls, things weren't progressing so well in Wichita, so the choice was easy.

What followed was a three-year effort to get state and local government to help finance the airline. David Johnson, a prominent Tulsa lawyer and counsel to the airline, helped push through state legislation that would give the tiny airline tax credits that it could sell to raise money. Last year, through a combination of tax-credit sales and a loan from the Bank of Oklahoma, with property put up as collateral by the city of Tulsa, Great Plains managed to amass $30 million in start-up capital. (Today, Mr. Johnson is an investor in Great Plains and sits on its board.)

Is $30 million enough? "The one big problem is, they are undercapitalized," says Darryl Jenkins, director of the aviation-studies program at George Washington University and a consultant to several airlines, including American. He notes that JetBlue Airways, a successful low-fare carrier that serves upstate New York, Florida and other locales from a base at New York's Kennedy airport, took off in early 2000 with a $160 million bankroll.


John Knight

The Great Plains executives point out in their business plan that AirTran, Reno Air and several other airlines managed to start up in the 1990s with initial capitalization of $20 million or less. In 1998, Reno, after several years of both profits and losses, was sold to American Airlines for $124 million. They also note that JetBlue started out on a much larger scale and from a more expensive base in New York City.

Pair Braves the Odds in Bid to Build an Airline

Without a huge bankroll, Great Plains would have to take on a tremendous load of debt to buy a handful of the planes it wants at $20 million apiece. Instead, it wants to lease them, at an estimated $160,000 a month per plane. That means gaining entree to the arcane world of aerospace finance.

Mr. Knight started doing that three years ago through boyhood friend Jim Barkas. "We played football together 41 years ago in Port Jefferson (New York)," Mr. Knight recalls. His friend was working at Newcourt Capital in New York City, and in the same office was Edward Holub, a senior executive in the field of complex transactions known as "structured finance."

"It's not like leasing a car," Mr. Holub says.

Mr. Knight and Mr. Holub met, and every three months or so, Mr. Knight gave progress reports on Great Plains. When Newcourt was later acquired by financing company CIT Group Inc., Mr. Holub stayed on at CIT as a managing director.

The airline founders also have had a foot in the door with Embraer since 1996, when they were on the prowl for an airline to buy in Florida. At that time, they visited Embraer's Fort Lauderdale offices, just as the company, privatized by the Brazilian government two years earlier, was delivering its first jets to Continental Airlines. They made a point over the years of cultivating finance executives at Embraer. So by the time of the Puerto Rico conference, sponsored by CIT Group, the Great Plains founders knew what they were dealing with and had $30 million in financing to bolster their sales pitch.

Ideally, to get their planes, Messrs. Knight and Swartz would operate under the "umbrella" of Embraer in a deal possibly involving CIT, whereby the Brazilian company would provide incentives for third parties to in effect buy the planes and lease them to Great Plains. One thing manufacturers sometimes do in such deals is stipulate the "residual value" of the jet at the end of a lease—a means of assuring the financiers that they can expect a minimum resale value for the plane. That would be especially important in the case of Embraer: Its jets have been on the market for only a few years, and thus lack a reliable market standard for resale valuations.

It won't be easy. Great Plains is competing for the regional jets against larger, established carriers with proven financial track records, including the Comair unit of Delta Air Lines and SkyWest Inc.

So "the question is: Does this airline pass the sniff test?" Mr. Knight says.

Earlier this month, the entrepreneurs delivered to Embraer the completed documentation required for a deal. Mr. Swartz is confident they will get their first delivery by the end of September.

'Technically Possible'

Embraer executives confirm that negotiations with Great Plains continue. "The possibility of deliveries in late 2001 depends upon how long it takes us to reach the final agreement, but it is still technically possible," says Frederico F. Curado, executive vice president of Embraer. Mr. Curado says Embraer doesn't provide direct financing for its customers. But he adds that Embraer "will try to help Great Plains to obtain the necessary financing for these airplanes."

Even with aircraft, Great Plains couldn't fly without certifications from the Department of Transportation and the Federal Aviation Administration. The two founders had a choice: "build" their certifications from scratch through an application process that could take six months or more, or buy an airline already certified, with key personnel and planes.

By March, they were in serious negotiations to acquire Ozark Air Lines. The parties won't dislose terms of the deal struck later that month. But along with Ozark's two 32-seat Fairchild aircraft and 75 employees, Great Plains got the certification it needed. (It will need further, less-cumbersome certification to fly the Embraer jets.)

The Ozark acquisition kicked Great Plains into high gear. The two 32-seat Ozark jets produced by Fairchild Dornier Corp., a German-American company, have a range of only 800 miles, so they can't fly nonstop from Oklahoma to the East Coast. Great Plains shut down Ozark's flights into Dallas/Fort Worth and began planning to redeploy the Fairchild planes for shorter hops in its hub-bypass strategy.

That's really only a holding pattern, though, since Great Plains won't be able to make full use of the Embraer jets it hopes to get if it can't get takeoff and landing slots at Reagan National Airport in Washington. Great Plains is requesting 12 slots, six departures and six arrivals daily.

But here, Great Plains is flying into a hurricane. National and New York's LaGuardia, its other target destination, are among a handful of U.S. airports where takeoff and landing slots are allotted by the Department of Transportation. For now, the effort to fly to notoriously overcrowded LaGuardia is on hold.

That leaves Reagan National, and Washington being the nation's capital, politics often play a big role in how the DOT allocates National's slots. Today, 66% of the 771 slots at National are controlled by four airlines: United, American, US Airways and TWA. With United and American seeking control of US Airways and TWA, some smaller airlines say the oligopoly is on the verge of becoming a United-American duopoly. By some calculations, post-merger American would have more than 50% of the takeoff and landing slots at National. Many smaller airlines are lobbing protests at regulators and Congress, complaining that only 1.2% of the slots are allocated to newcomers.

For its own part, Great Plains is cranking up its lobbying efforts. J.R. Reskovac, a lobbyist from Lawton, Okla., who has worked in Washington for 14 years, has been explaining Great Plains' ambitions—and what it could mean for Oklahoma's economy—to the Oklahoma delegation of two senators and six representatives. Mr. Reskovac says he may eventually ask the Oklahoma delegates to press Great Plains' case with their colleagues and senior DOT staff. Partners at Mr. Reskovac's firm, Van Scoyoc Associates Inc., have also been talking to the DOT directly on Great Plains' behalf since the Ozark deal. Leading that effort is Steven Palmer, who joined the firm after 20 years on Capitol Hill, including a stint as assistant secretary at the DOT.

"It's a difficult process . . . but I'm an optimist by nature," Mr. Swartz says. One possibility, he says, is that in the consolidation of the industry, some existing slots controlled by the major carriers will be freed up for newcomers.

The Ozark acquisition also helps because it has brought another state into play. The way Great Plains and its lobbyists figure, if Missouri's delegates help Great Plains get the slots it wants, the airline can in return offer flights between the capital and Columbia, Mo., a university town near the state capital of Jefferson City.

One recent morning, Mr. Swartz paid a visit to Capitol Hill, where he ran into a staffer for Kenny Hulshof, the Missouri representative of the Columbia area. "I said, 'Wouldn't your boss like to fly home nonstop at 4:30 on a Friday afternoon?' " Mr. Swartz recalls.

Matt Miller, press secretary to Rep. Hulshof, confirms that Mr. Swartz spoke to fellow Hulshof staffer Shelby Neel last month. The airline executive didn't ask for any specific help, according to Mr. Miller, who adds: "TWA is our chief interest, but we welcome Ozark or Great Plains, anything that helps us with transportation options."

Providing such options is what Messrs. Knight and Swartz say will help Great Plains avoid the pitfalls that have sunk many other start-ups. In the past, a start-up comes into a lucrative hub such as American's Dallas or United's Chicago with discount fares. The major matches the fare, increases the frequency of its service, and waits for the newcomer to switch to another route or run out of money.

Great Plains won't be a discounter; it plans to match the fares of the majors. It figures it can fly the Embraer jets less than half full and still break even. And by offering direct service, particularly to Washington and New York City, it won't fly into the hubs of its rivals.

No Guarantee

But that's no guarantee against retaliation. Legend Airlines, founded in 1996, challenged American with high-end service between Dallas's Love Field and several East and West Coast cities. American launched its own first-class service in competition. With accumulated losses of $40 million, Legend recently filed for bankruptcy protection.

Ominously, American has a huge presence at the Tulsa airport. Directly across the tarmac from the Great Plains office where Messrs. Knight and Swartz work when they aren't on the road sits a huge American Airlines maintenance facility. American already routes lots of empty jets through Tulsa for overhaul, and it wouldn't take much to start flying some of those planes directly on Great Plains routes.

On Great Plains' side is a pending Department of Justice antitrust complaint against American, accusing the airline of using predatory tactics on three other start-up airlines—Vanguard Airlines, Sun Jet International and Western Pacific—by slashing prices and adding flights on routes the newcomers were flying. American denies the allegations.

But on Nov. 1 last year, before Great Plains even had a plane, American initiated daily nonstop service aimed at business travelers between Tulsa and Los Angeles.

"With respect to Tulsa, it is the location of our largest maintenance base, so there's extra interest in trying to be one of the most desirable airlines offering service to and from Tulsa," says an American spokesman. The Tulsa-Los Angeles service "was not added in anticipation of Great Plains entry," he adds, but was done to position planes for maintenance and to bolster American's presence at Los Angeles International Airport, where United Airlines has a stronghold.

Flying to Los Angeles is no longer a top priority at Great Plains, Mr. Swartz says.

Lacking the planes and permission it needs to fly to the East Coast, Great Plains on Friday, April 6, inaugurated its first scheduled service: daily flights on one of the Fairchild jets between Tulsa and Nashville. Northwest Airlines offers Tulsa-Nashville service with a connection in Memphis. Mr. Swartz says Great Plains is booking more business than expected on the route, but he declines to be specific. In any event, Great Plains is airborne.

Says Mr. Swartz: "We're no longer just a wannabe."