Stormy Skies, and a Silver Lining, for Boeing

Published : July 03, 2002 in Knowledge@Wharton

Good company. Too bad about the market.

By most accounts, Boeing has pulled off a turnaround in the past five years. The company has streamlined production, bought a profitable military-aircraft business and clarified its famously unreadable accounting statements.

But the nation's only major commercial aircraft manufacturer is still yoked to the airline market, and that market is downbeat, to say the least. Airlines teeter on the edge of bankruptcy, and thousands of planes sit idle in the Arizona desert.

Boeing's response, says Lew Platt, a Boeing board member and former CEO of Hewlett-Packard, is diversification. "We're trying to reduce our dependence on commercial aircraft – which is a very cyclical business and happens to be in a very big downdraft at the moment – and [increase] business that comes from military aircraft, space and some new initiatives," he says.

Getting With the Program

Five years ago, Boeing was in trouble. Simultaneously trying to hire thousands of new employees, ramp up production and implement a new just-in-time manufacturing system, the company eventually had to shut down the 737 and 747 production lines for a month in late 1997. Because of thundering cost overruns, Boeing reported a $178 million loss on $45.8 billion in revenues that year.

"Basically, a giant spasm went through the company's final assembly production process," says Wharton management professor Dan Raff. "It was a little bit like a python swallowing a guinea pig – it really took quite a while to digest the organizational change it was implementing."

A *BusinessWeek* cover story in May 2002 took a critical look at Boeing management's approach to the crisis, arguing that management leveraged the unusual "program accounting" system used in the aerospace industry to delay telling shareholders about the production problems until the merger with McDonnell Douglas in 1997 was complete. "Program accounting gives senior executives more power to estimate the numbers than any other system," says Stanley Holmes, one of the writers of the *BusinessWeek* article.

Program accounting was developed by aircraft manufacturers because airplanes have massive start-up costs, but most of their revenues come years later. With program accounting, executives average out costs and profits over a decade or so, reporting both profits and costs each year. It's a similar method to accounting for long-term projects in the construction industry, accounting experts say.

Platt, who is a member of Wharton's Board of Overseers, admits that program accounting puts a lot of responsibility on management to be honest with estimates. But he argues that it's the best way to deal with the cost structure of the airline business. " Certainly program accounting requires more judgments than cash accounting, but many people take frequent independent looks at the estimates to insure they are still reasonable. That includes the board and the auditors, neither of whom assume the judgments are correct just because management proposed them."

The company has also made moves to clear up its accounting practices since 1997, Holmes says. "They actually hold conference calls with investors and journalists … they [also] provide more information in both their quarterly reports and in their annual reports. That certainly wasn't the case in the past."

A New and Expanded Boeing

Commercial airplanes shouldn't dominate the new Boeing the way they did the old, Platt says. Boeing's profits have always been stormy, reflecting the cyclical nature of the commercial airline business. So the company swept up defense contractors such as Rockwell and McDonnell Douglas in the late 1990s, building a solid business which now represents 40% of Boeing's revenues, according to the company's 2001 annual report.

The company underscored its effort to diversify by moving its headquarters from Seattle to Chicago in September 2001 – thousands of miles from their commercial airplane assembly lines. "It's a little hard to know what the significance of the move was," Raff says. "It's surely tied up with the notion that it's not clear in their minds that they want the airplane manufacturing part of the company to be driving the biggest decisions."

The company's military-aircraft business is doing well, bringing in a healthy $363 million in 1Q 2002. Top Boeing military products include an unmanned fighter plane currently being evaluated by Washington, and various parts of the National Missile Defense system, President Bush's "Son of Star Wars."

And by all accounts, the company has streamlined its production process. New 737s are being made by two shifts of workers with 14 airplanes in the factory. It's a big change from 1992, when simpler, older 737s required three shifts and 29 airplanes on the floor, according to the company, which projects that the 757 line will get the benefits of this "lean" manufacturing process later this year.

Unfortunately, diversification and cost-cutting haven't shielded Boeing from the brutal effects of the air travel downturn and a weakness in its space-satellite business. Boeing showed a $1.2 billion loss for the first quarter of 2002, compared to $1.2 billion in net earnings for the same quarter in 2001.

Most of the loss came from an accounting rules change forcing Boeing to face up to the loss in value of the Hughes space and satellite business which it acquired in 2000, at the top of the previous market. But net earnings were down, largely because of increased costs, even before the one-time, $1.8 billion after tax accounting charge. Analysts predict a relatively weak 2002 and 2003 because Boeing's commercial aircraft business is now competing with airlines' own grounded planes.

The company is also entering contract negotiations this year with its historically restive unions, who most recently went on strike in 2000. Boeing laid off more than 20,000 workers in the wake of September 11.

Boeing is trying to focus on profits rather than market share in the current downturn in commercial aviation, Platt says. "We're now able to take the volume up and down so we can meet demand when demand is high, reduce capacity when demand is low and still make money."

Boeing vs. Airbus

With airliners taking a decade to develop, deciding upon new products at an aircraft company requires nearly-mystical powers of prognostication. After interviewing the same customers and analyzing the same data, Boeing and its chief competitor Airbus have come upon nearly-opposite ideas for where the future lies.

“This could turn out to be a ‘you bet the company’ decision that Boeing is making here,” says John Percival, adjunct professor of finance, who plans to present these wildly divergent views of the future at a Wharton executive education program this summer titled “The CFO: Strategic Partner to the CEO.”

Boeing’s bet is that air travel will decentralize. Instead of many flights per day between a few international gateways, Boeing sees point-to-point flights crisscrossing the Pacific. That would require a small, fast, efficient plane – Boeing’s 300-seat Sonic Cruiser, which may come into service in 2008 if the company decides to go ahead with the project. “The idea of being able to fly quickly from point to point rather than flying a behemoth aircraft from hub to hub and then catching another flight to get where I want is the way to go,” Platt says.

Airbus, on the other hand, is betting that the airways are becoming too crowded already and that hubs will remain intact. Flying teeming masses from London to Hong Kong or Los Angeles to Tokyo would demand a huge jet, the 500-plus seat A380, scheduled to come into service in 2006. “You’ve saturated the airways … there’s just too much traffic. The average airplane’s got to get bigger. Eight 747s leave from Hong Kong to London within an hour every night,” notes Tom Ronell, a 1976 Wharton graduate and president of an aviation consulting firm.

Both manufacturers may end up winners, Platt says. “Two companies have gone out, talked to the same people, gotten what they think are different inputs, and they’re pursuing really quite different strategies. There aren’t too many times where you will get such different conclusions, and it probably means that there’s room for both airplanes.”

One thing Boeing and Airbus do agree upon is that there’s a profitable future in providing Internet services aboard planes. Boeing has British Airways and Lufthansa on board for its Connexion by Boeing product (even though three U.S. airlines pulled out after Sept. 11), and Airbus is a major investor in rival Tenzing Communications.

Two Views of the Future

According to a June 20 report from SalomonSmithBarney analyst George Shapiro, Boeing at the moment can’t do anything right. While Shapiro applauded Boeing’s increases in efficiency during the recent past, he says that doesn’t translate into an attractive stock in the short term. “Ordinarily one might expect such gains in cost cutting to lead to improved profitability and earnings growth, but for the continuing down cycle in the commercial aircraft industry,” he wrote.

On the other hand, a June 10 online report from CNN Money picked Boeing as one of six stocks to invest in, despite a list of recent woes that include, for example, delivery of just 380 planes in 2002, down from 527 last year and expected to drop to below 300 next year; and the recent loss of the Joint Strike Force fighter contract to competitor Lockheed Martin.

But these setbacks, CNN Money concluded, “have driven the stock price so far down that investors [can] buy one of the country’s great industrial companies on the cheap.” The article also noted that Boeing’s stock trades at “almost 14 times this year’s estimated earnings vs. an average of 19 times for major aerospace and defense companies” and cited Boeing’s readiness to meet orders for jets once airlines’ demand for them rebounds.

Perhaps it’s fair to say, as do Deutsche Bank analysts Christopher Mooray and Alexander Motamed, that Boeing is a better long-term bet than short-term buy.

Or, as Lew Platt notes, it will take a few more years and a shakeup of the airline industry for the commercial aircraft business to sort itself out. “We think in terms of a real uptick in the commercial business … probably by late 2004 or 2005. It’s not going to be this year, and it’s not going to be next year.”