

# Preface

From a financial management perspective, it is undoubtedly true that probably the most challenging industry in the world today is the airline industry. The industry is faced with significant internal competition, while from the outside it is subject to sometimes capricious government controls in the form of security requirements that are levied on no other industry of comparable size. Low-cost airlines have intensified fierce domestic competition, while legacy airlines have been burdened with holdover labor contracts (that date from the inefficient period of regulation) and severe merger problems that have arisen owing to different cultures between merged airlines. In addition, heightened security concerns have disrupted schedules, forced flight cancellations, and severely inconvenienced the traveling public. Since almost all decisions in this (and any other industry) depend on an appropriate financial management background, the authors of this text, with many years of teaching aviation finance in an academic setting, active consulting in the industry, and actual industry decision-making with individual airlines, feel that there is a need to prepare prospective participants in airline management (as thoroughly as possible) in the intricacies of managerial finance as it applies to the industry. Therefore, for all of the reasons mentioned above and more, it seems to us that this is an appropriate time to publish a basic financial textbook that covers the fundamentals of financial management in the airline industry. The textbook covers the fundamentals of financial management that are appropriate to any firm or industry and, more importantly, the differences that characterize managerial finance in the modern airline industry. To that end, we have developed a step-by-step approach that addresses financial decision-making from both a theoretical and a practical point of view. And, while the text can certainly be used as a basic introduction to finance, it is mainly aimed at aviation professionals and students who have a desire to enter the aviation industry in a management capacity.

The text is divided into four more or less self-contained sections that progress from the theoretical foundations of financial management to more sophisticated practical applications of the theoretical concepts. The first section lays the necessary theoretical foundation for the critical concepts that are needed to understand financial management in the airline industry. Chapter 1 gives an overview of the importance of finance in the industry. The chapter describes the truly global nature of the industry and introduces the reader to important concepts that are covered in more detail later in the text. This chapter is followed by a chapter that gives a detailed discussion of the true nature of costs within the industry. The misconception surrounding the nature of fixed costs and their application to financial decision-making is one issue (among many others) that receives much needed coverage. Following this chapter the critically important topic of the time value of money is explained in clear and straightforward terms. Informative and simple numerical examples are used to illustrate this important concept, thought by some to be the most important theoretical idea in the field of financial management. Finally, the last chapter discusses the important roles of risk and return in financial management. Various methods that are used to evaluate these concepts are discussed and illustrated in the context of the aviation industry.

The second section of the text introduces the reader to the use of financial statements to evaluate the actual position of the firm in the industry. And, some significant differences between airline accounting and more traditional accounting are highlighted and explained; for example, the treatment of frequent flyer miles in the accounting statement. The first chapter of this section covers the accounting statement and how to read and understand it. This is followed by the role of financial statements in understanding the position and prospects of the individual firm. Finally, the actual techniques for analyzing all of this information are explained and illustrated with concrete examples.

The third section of the text provides a clear exposition of capital budgeting within the industry. This topic is yet another critically important financial concept that differentiates the airline industry from other large capital intensive industries. The reason for this is the fact that the fungible nature of the capital assets (that is, aircraft) makes the situation unique for the airline industry. Among other important topics, capital budgeting in the context of the Capital Asset Pricing Model (CAPM), the Weighted Average Cost of Capital (WACC) and various stock valuation models are covered in the opening chapter of this section. This chapter is followed by a chapter that discusses the overall airline capital structure and the important methods (equity, debt, retained earnings, etc.) associated with acquiring that capital. The final chapter of this section discusses the ideas of working capital and current asset management.

The last section of the text is quite probably the part that will be of greatest interest to airline professionals, since it explains and gives examples of some important practical applications of financial management. The section is introduced with the important practical concept of hedging. Hedging protects an industry or airline from the fluctuations of price in the marketplace and, in particular, the volatility of fuel prices, which is generally the single highest expense for any airline. However, hedging is not without its own risks, and these are discussed at length in the chapter. The next chapter in the applications section concerns the all-important buy versus lease decision for any airline within the industry. This topic, although covered at some length in various articles on aviation finance, has not received (in our opinion) sufficient in-depth coverage in basic aviation finance texts. The underlying ideas and quantitative assumptions and rationale for either decision are discussed and evaluated in the chapter. Finally, the issue of valuation is covered in the last chapter of this section. The critical question of what an aviation asset (generally an aircraft but sometimes an airport in the era of privatization) is worth is addressed and, more importantly, a method for actually calculating this value is presented in some detail.

In summation, it is our hope that the text will find an interested audience in both academia and the aviation industry.