

## **IAM Strike Over, Challenges Remain**

The strike by the International Association of Machinists (IAM) is over at Boeing, but challenges remain from its own internals and the uncertain global economy.

After 58 days, the IAM began returning to work for the third shift on November 2; by agreement, the entire workforce doesn't have to be back until November 10. According to Boeing CFO James Bell, it could take as long as two months for production to return to pre-strike levels, making this easily the end of the year and potentially to the middle of January.

How long will it take Boeing to catch up on the deliveries of about 80 jets delayed during the two month strike? That depends. Boeing has no plans to boost production to play catch up; the best hope is that deferrals or cancellations can enable the company to do so sooner rather than later. Boeing said during its earnings call that so far it has had just two cancellations and 80 deferrals due to the economic turmoil, but that other customers quickly grabbed these production slots.

More airlines are now talking about deferrals; the latest is China Eastern Airlines, but no details were given in the news report by ATW Online about which airplanes may be deferred. All of China's Big Three carriers (Eastern, Southern and Air China) have had poor financial results and are asking for government aid, according to ATW. China's airlines historically have been a stalwart customer, reliable through world economic ups and downs. China Eastern's deferrals and financial instability may only be a harbinger of things to come.

While on the one hand, the deferrals would be bad news for Boeing, these would allow the company to catch up in reasonably short order from the strike.

(Although the focus of this commentary is on Boeing, Airbus is also at risk of deferrals and, by most accounts, more so because of the dicey quality of more of the order book. Historically, Airbus sees more cancellations and deferrals than does Boeing.)

With the IAM strike behind it, and the tangible benefit that this is a four year contract instead of a three year deal, Boeing still has plenty of challenges from within in addition to the global uncertainties. These include:

- The recovery period from the IAM strike. The financial immediate impact will continue through the fourth quarter and likely into the first quarter. Longer term, the financial impact will be years, based on an analysis by Seattle Times reporter Dominic Gates of the previous IAM strike of 2005.

- The contract negotiations with SPEEA, the engineers union, are underway. Only four days of “table negotiations” have been completed as of today and it’s too soon to draw conclusions about how these talks are going. This contract expires December 1. If talks fail and a strike vote passes, SPEEA officials said they would schedule a strike in January—coincidentally, as it turns out, right as Boeing would be back to pre-strike levels from the IAM walkout.
- The first flight of the 787 remains uncertain. We heard before the IAM strike that the flight was slipping to January or February. With a day-for-day delay due to the strike, we think it likely the first flight won’t occur until late in the first quarter or even the second quarter. Technical issues continue to arise that cumulatively add to the first flight’s uncertainty, we are told. These are not issues of any particular consequence and are largely expected at this stage of development, but the combined effect simply takes time to sort out. Furthermore, according to ATW Online, ANA now expects its first 787 delivery in 2010 (from August 2009) and Qantas expects an additional six months delay in receiving its airplanes (also according to ATW Online). Extrapolating backwards, this suggests similar additional delays in the first flight.
- Boeing acknowledged new challenges in the 747-8F program during the earnings call. Engineering resources from the 747 program (as well as others) are still diverted to the 787 and technical issues are emerging on the 747 program, we are told. Two customers we’ve talked to expect delays of 9-12 months, compared with the six months in the consensus aerospace analysts estimates.
- The P-8A Poseidon sub-hunter airplane is over weight, we’re told. This airplane is based on the 737.
- The flight testing of the 777F is behind schedule, at least partly from the IAM strike, because of the absence of mechanics to fix what pilots found in the flight testing. First delivery is expected to be delayed, we’re told.

**On top of all this**, Boeing faces the challenges of future airplane programs. What will it do about the 737 and 777 replacements? Will the company rely on “refreshes” for the next decade or go all-in for new airplanes?

What will Boeing do about the possibility of a second 787 production line? The company said in its program update last April that it plans to go to 10 a month by 2012, but this doesn’t solve the problem of the ripple-effect from the program delays. Except for slots reserved for American, Continental and Delta airlines (based on preferential supplier contracts dating to 1996-97), there are no production slots before 2017-2020. The only way Boeing can accelerate the delivery delays and/or offer slots sooner is to hike production beyond the announced 10 a month. If Boeing is facing additional delays, as ANA and Qantas suggest, this makes it all the more imperative that a second production line be opened. The question is when and where.

Significantly, Mike Denton, VP-Engineering for Boeing and a key negotiator in the SPEEA talks, said that because of the snafus in the 787-8 program, more design and production on the 787-9 will be retained by Boeing. This should be music to the ears of SPEEA and the IAM. A key contract gain by the IAM was the right to bid on any work that Boeing wants to outsource from the Puget Sound (Seattle) area to any other Boeing facility. Since the first 787-9 delivery is scheduled for 2012 (absent any strike-induced or other delays), presumably this work Denton refers to ought to be established prior to the IAM contract expiration September 8, 2012.

This means Puget Sound should have first crack at this work. The IAM wants to see the second 787 line established at Everett (WA), where the first 787 line is located. The IAM points out that Boeing's prototype composite fuselage production is sitting in a warehouse by Boeing Field, and this (they believe) could form the basis of Line 2.

There is a lot of speculation that Line 2 might wind up in San Antonio (TX), where some final 787 fitting out was (is?) planned at a Boeing facility. Texas is a right-to-work state and there are those in Boeing who are fed up with facing labor strikes every three (or four) years from its two major unions. The feeling is why not set up Line 2 (and the assembly sites for the 737 and 777 successors) in a right-to-work state and be done with the militant IAM in Puget Sound?

The dynamics are evident when it comes to selecting the site for Line 2, but we think a second line is a must. A Boeing insider suggested months ago to us that two lines of seven a month would make a lot more sense than one line of 10 or 12; it would allow better management in cyclical times and the production of 14 a month would provide catch-up and new delivery slots.

It looks like the IAM will have the chance to bid on this important work, as a result of the new contract. Let's hope the time comes sooner rather than later in order to get the 787 program back on track.

### **Who is the largest Boeing customer?**

As often happens when we are researching something, we either come across or develop information that is interesting on a different topic. Thus, while working on one thing we created some charts that answer the question, Who is the largest Boeing customer?

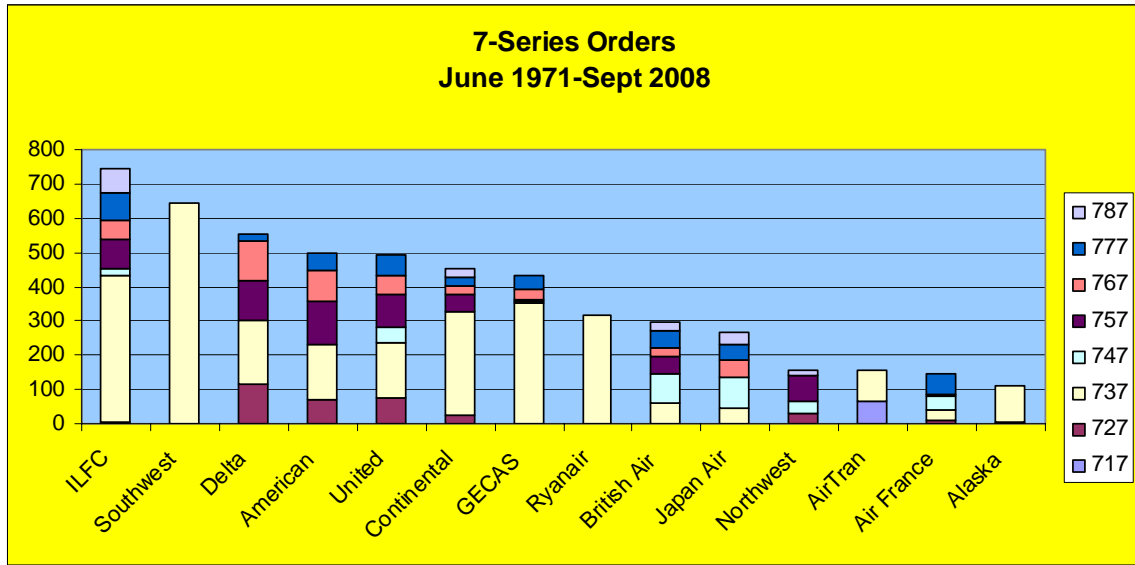
Mega-lessor International Lease Finance Corp. is commonly regarded as Boeing's biggest customer (Airbus', too). ILFC placed its first new airplane order with Boeing in 1971, so the clock in the exercise starts ticking then. ILFC has ordered 747 7-Series airplanes since then. (McDonnell Douglas orders don't count; all such orders were placed before Boeing merged with MDC; therefore we also disregard any MDC orders in comparing ILFC with any other company.)

In the first chart on the next page, we compare ILFC with other key customers worldwide, and the second largest Boeing customer will surprise many readers. The second largest customer placed its first order with Boeing in June 1971, so that's when the clock starts in the two charts below.

Who is the world's second largest Boeing customer? It's Southwest Airlines of the USA, with 643 orders, all of them 737s. Southwest has launched the 737-300, -500 and -700 series and may well be the launch customer for any 737 refresh or successor airplane. The company is pressing Boeing to dramatically improve the fuel burn of the 737 or launch an entirely new airplane.

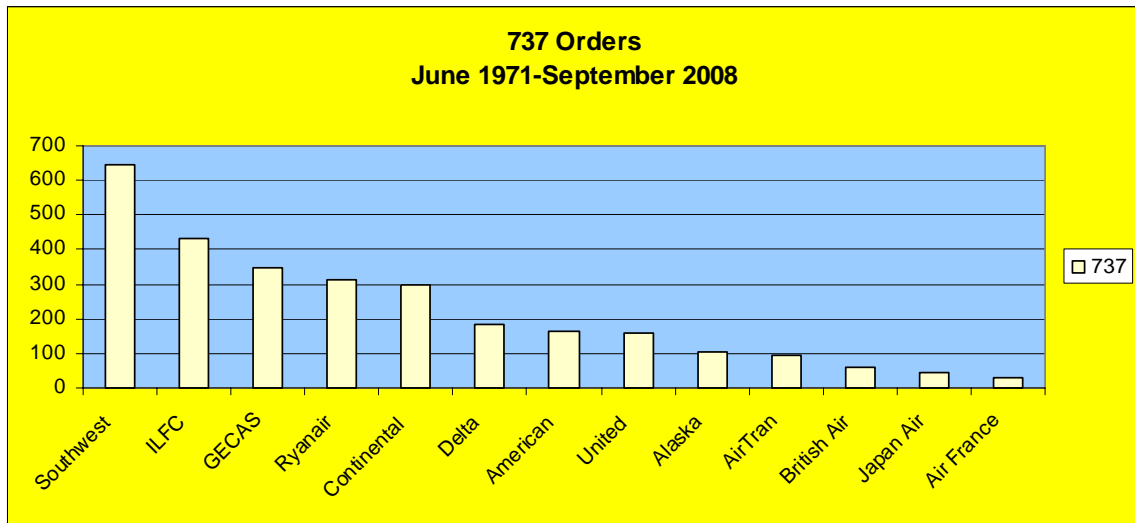
Southwest is by far the largest 737 customer in the world (Chart 2).

**Chart 1**



**Source: Boeing**

**Chart 2**



**Source: Boeing**

*By Scott Hamilton, November 4, 2008*