Japan Airlines, long a symbol of the country’s global place in the aviation industry, jolted the nation earlier this year when it filed for bankruptcy protection and set in motion a process of restructuring.

Kazuhiko Toyama, who was a member of the JAL Reorganization Task Force, provides an inside perspective how what happened and what still needs to be done to revive the carrier.

ON JAN. 19, 2010, Japan Airlines (JAL) filed for bankruptcy protection in the District Court of Tokyo along with its subsidiaries, Japan Airlines International and JAL Capital. The Enterprise Turnaround Initiative Corporation (ETIC), a state-backed turnaround body, officially announced support for JAL’s reorganization the same day.

The reorganization plan announced by ETIC consists of the following five major points:
• Improve reliability;
• Improve efficiency by using smaller aircraft;
• Give up unprofitable routes and pursue synergies from various business alliances;
• Establish efficient human resource management and improve use of human resources;
• Establish a mechanism that will allow swift decision-making.

In addition, ETIC and the Development Bank of Japan (DBJ) announced a new 600 billion yen (US$6.6 billion) line of credit for an immediate cash infusion, along with ETIC’s 300 billion yen capital infusion.

Why was this kind of assistance necessary to sustain JAL? What are JAL’s fundamental problems and how can the company be rehabilitated? Moreover, from a macro-economic policy perspective, what are the challenges of a court-led reorganization funded by the state?

I served as the chief operating officer of the Industrial Reorganization Corporation of Japan, on which ETIC is modeled, and on Sept. 25, 2009, was assigned to the JAL Reorganization
A young JAL employee stands at a deserted check-in counter at Tokyo’s Narita Airport on Jan. 19, the day the airline filed for bankruptcy protection.

Photo: Everett Kennedy Brown / EPA
Taskforce, created under the command of the Ministry of Land, Transport, Infrastructure and Tourism. During my time with the task force, I worked extensively on an analysis of the company and worked out the reorganization plan. I would like to share my experiences and discuss the fundamental problems of Japan Airlines.

First, JAL’s difficulties can be categorized into two major groups: 1) deep-seated and chronic problems; and 2) acute problems that became more serious after the Lehman Brothers crisis in 2008. The immediate short-term issue was how to avoid a cash shortage and keep the planes flying.

In the case of the airline industry, operating costs are mostly fixed, such as wages, aircraft lease payments, fuel and maintenance costs. JAL had been under a chronic operating cash shortage as it had excessive fixed costs while its income steadily declined during the economic crisis. There have been a number of airlines around the world that couldn’t pay for their daily operations and temporarily stopped flying. Those cases eventually ended in bankruptcy and, in most cases, liquidation, since brand equity immediately erodes the moment an airline is grounded. JAL was on the verge of entering such a dangerous scenario due to its cash shortage.

When a patient is severely ill and has already been bleeding excessively, the only way to cure it may be intensive surgery to eliminate the fundamental causes of the disease. However, performing surgery on a critically-ill patient involves great risks and, moreover, a massive blood transfusion. JAL’s situation was the same. It needed to take fundamental measures such as voluntary rehabilitation proceedings or court-led reorganization. JAL also needed a huge amount of cash — as much as 1 trillion yen in the in case of a court-led bailout in order to cope with credit loss. In the current financial environment, only the state could provide such an amount of risky money in a short period of time. Thus, the reorganization taskforce came to the conclusion on Oct. 20, 2009 that only the Enterprise Turnaround Initiative Corporation, a state-backed institution, had the legal capability to provide such a huge amount.

We also concluded that JAL would face a critical cash shortage by the end of November or early December at the latest. We explained that nearly 200 billion yen would be needed for the period up to the end of March 2010. With this final recommendation, the taskforce ended its mission on Oct. 29, 2009.

The DBJ provided financial loans twice, amounting to a total of 200 billion yen from that point to Jan. 19 of this year, when ETIC officially announced its full support. Thus, JAL was able to keep its planes flying and avoid liquidation.

In the end, they chose to go through a court-led reorganization and announced a new credit line of 600 billion yen with a 300 billion yen capital infusion, all of which were what we, the taskforce, had predicted through our analysis.

Although it appeared that the process went through various detours, I am personally very relieved that the related parties were able to meet the conditions that needed to be assured upon entering a state-backed bailout involving various complex international interests and legal issues.

I must also add that Transport Minister Seiji Maehara understood our recommendations very thoroughly and never diverted from the most critical issues, i.e. that the airline must be kept flying in order to achieve rehabilitation, that drastic measures and a huge amount of cash were needed immediately and that the government must be able to provide overall support for JAL’s global operations.

ELIMINATE JAL’S HUGE LEGACY COSTS

We will now focus on the chronic problems that led JAL to the brink.

In short, the company had too many aircraft, too many personnel and too many routes. The flight routes are not the direct components of fixed costs, so eliminating the unprofitable routes alone will not solve JAL’s situation. The more severe issues are planes and personnel. As Narita Airport imposes limitations on the share of slots, JAL, with its focus on international business, chose to compensate for the limitation by operating big planes — namely Boeing 747s. These planes, however, became uncompetitive assets
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as the industry standard moved towards more efficient smaller aircraft.

As for personnel, the JAL group had a total of about 50,000 employees, which was considered about 30 percent too many. Although JAL had been known for its aggressive recruitment in the past, it decreased the number of new hires starting in 1975 as the industry became more competitive and the company faced a business downturn. This caused a “reverse-pyramid” effect in the company’s human resource structure, with too many veterans and too few young employees. Cost reduction efforts were mainly achieved by targeting new recruitment, and only limited measures were taken to reduce the benefits of existing and retired employees. JAL failed to take drastic measures even upon the merger with Japan Air Systems. It continued to pay as much as 500,000 yen (US$5,500) a month to some retired employees while there were ground-based employees in their 30s who were paid less than 200,000 yen a month.

Although the Japanese public perceives JAL as a company with good pay and benefits, nothing could be further from reality. The younger generations in the company have high potential but have been weathering tough conditions. At the same time, however, they are also free from old corporate restraints. One of the reasons that Kazuo Inamori, the founder of electronics giant
Kyocera, was nominated as the new chief executive officer of JAL was precisely to have him bring out the potential of younger staff members.

As for the financial liabilities, JAL not only has bloated bank loans but also pension liabilities and losses from fuel-related derivatives that were aimed at compensating for business losses. By the end of fall 2009, JAL had negative assets of over 800 billion yen, close to the amount of financial liabilities calculated by ETIC.

**SEARCHING FOR SOLUTIONS**

We now turn our attention to the remedies that JAL needs to take going forward. First and foremost is the elimination of the negative assets and the practices that caused the problems. Taking on the issues involves pain to all parties involved, including existing employees, retired employees and politicians. The company and the related parties have all denied reality for too long, allowing JAL to collapse. Now, as the court-led process begins with a huge amount of state money, they must take advantage of the opportunity and eliminate past negative practices.

First, JAL must establish a new executive management team that consists of young and talented employees. Under the leadership of Inamori, the company must eliminate internal and external “noises” and confront its past. Under the guidance of the court, JAL will be able to impose more sacrifices on creditors and cut a substantial amount of its financial burden (over 700 billion yen, according to ETIC’s plan). The problem with the pension liabilities has already been partly solved because the company was able to obtain consent on a 45 percent average reduction of its pension obligations. The existing aircraft will be substantially written off, thus allowing the company to eliminate inefficient Boeing 747s and introduce new mid-size and small planes that are more fuel-efficient.

As for personnel, ETIC is planning on reducing the workforce by 30 percent, or 15,000 employees. Although the number of employees will be naturally reduced by the sell-off of related and subsidiary companies, any employee reduction beyond this would have to be done by taking appropriate measures and paying severance, because the Japanese Rehabilitation Law does not override existing labor contracts. This process will be painful as it will involve not only the employees but also their families. However, the job must be done.

JAL must also keep its focus on its economics and withdraw from unprofitable routes immediately. The state money provided by ETIC is not to be used to sustain routes that are making losses. If it believes that there are routes that need to be kept to maintain the local economy despite their financial losses, the company must explain to the public and ask for approval to directly subsidize them using taxpayer money. The company must achieve such downsizing and balance its operating cash flow before it even talks about a growth strategy or the sell-off of its international business.

**EXIT STRATEGY: RE-GROWTH AND REGULATORY CHANGE**

JAL only has a maximum of three years of ETIC’s support. Based on my experience, it would have to start putting in place an exit strategy from year two. It will be a major accomplishment if it can achieve restructuring of this magnitude within a year. In reality, ETIC will have to begin the exit phase just as it has barely finished its restructuring to-do list. A re-growth strategy will actually be a part of the exit strategy. In considering this final stage, it is critical that the government swiftly adopt a full open-sky policy. This means allowing the airline companies to set international routes freely and eliminating restrictions on non-Japanese airline companies flying domestic routes.

The European Union (EU) airline industry is already fully deregulated, and the Association of Southeast Asian Nations (ASEAN) is moving towards an open skies policy. In the case of the EU, we are seeing industry reorganization through various mergers. The EU airlines now fall into one of three groups led by Lufthansa, Air France or British Airways. It may be possible that the industry will soon be divided into two camps instead of the current three. Star Alliance is increasing its members, and what they are actu-
ally doing is in essence a merger, achieving business and systems integration.

In such an industry environment, the only survivors will be either the super airlines and their affiliates or the low-cost carriers that serve niche markets. If ASEAN moves towards open skies, the rest of Asia will inevitably move in this direction. If Japan remains hesitant and continues to avoid industry competition, it will not be able to weather the challenges when it is finally forced to deregulate. Japan should embrace full open skies aggressively and learn how to win in a competitive environment.

The industry’s transition to open skies would solve the problem of domestic flights, allowing JAL to merge with ANA. It would also eliminate restrictions imposed on non-Japanese airlines, which would make it possible for JAL to be acquired by a non-Japanese carrier. JAL’s most valuable assets are the slots it holds at Narita Airport. Their value will only increase under open skies.

As the transition into open skies involves negotiations under the international air transport treaty, we must allow enough time for this strategy to bear fruit. The Japanese government should target amending the airline industry regulatory structure by 2011.

Although it is true that the Japanese government’s public policy on aviation was one of the contributing factors in the demise of JAL, we should consider this current situation the best opportunity to take an aggressive stance and strengthen the competitiveness of the Japanese airline industry. We must seriously consider how to connect Asian airline growth to Japan’s growth.

MINIMIZING MARKET DISTORTION AND CROWDING OUT

We must acknowledge that from a macroeconomic point of view, having the court lead the bail-out and state-backed ETIC provide the funds would inevitably cause market distortion. Market intervention skews the distribution of resources and hinders the mechanism that is supposed to eliminate an inefficient player. In this case, the loser gains cost competitiveness under the leadership of the court and can rise from the grave like a zombie. The supply-and-demand balance widens, and the original winner eventually could become the new loser. Court-led reorganization is often the target of discussion precisely because of these possibilities.

JAL’s dire situation, indeed, signifies that the market has been working effectively. What, then, can justify the Japanese government’s decision to intervene in the market to save JAL? The answer is JAL’s public role. If it were suddenly to go bankrupt and be liquidated, there would be a significant impact on Japanese daily life. It would also have a severe impact on the country’s international relations. Thus, the government’s focus should be on minimizing market distortion and being careful to maintain fair competition in the industry.

On the other hand, ETIC carries the responsibility of rehabilitating JAL and recovering the public money that it poured into the company. It is important that ETIC not misunderstand its role. It should focus strictly on increasing JAL’s corporate value.

Being a national company with a public mission, on the one hand, and being a private company facing severe competition, on the other, has long troubled Japan Airlines. In the end, its public characteristics allowed it to gain substantial assistance from the state. The truth is that the state provided the 900 billion yen as a form of “consolation money.” Three years from now, JAL’s repayment of its loans will be the consolation money from JAL to the state. The relationship that, for so long, exhausted both sides should finally be brought to a close. When ETIC completes its exit from JAL through a fair and transparent process and JAL re-enters the market as a truly independent company, we will know that the JAL rehabilitation process was a success.

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