



EXECUTIVE FOCUS

Corporate innovation at Southwest Airlines: An interview with Herb Kelleher, Founder & Former Chair & CEO

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Herb Kelleher co-founded Southwest Airlines in 1971 against significant odds. A practicing lawyer by trade, Kelleher fought through over 30 injunctions and lawsuits, including judgment by the U.S. Supreme Court, which commenced deregulation of the airline industry. Beginning with just three airplanes, Southwest now boasts a fleet of over 527 aircraft which make more than 3,400 flights per day. The firm's success is reflected by more than just travel statistics, however: From 1972-2002, Southwest Airlines provided the highest return to shareholders of any company in the S&P 500, amounting to a 26% return annually.

Mr. Kelleher has received numerous accolades, including induction into the U.S. Chamber of Commerce Leadership Hall of Fame, being named "CEO of the Year" and one of history's top three CEOs by *Chief Executive* magazine, being named "CEO of the Century" by *Texas Monthly* magazine, being named "U.S. Master Entrepreneur" by *Inc.* magazine, and being awarded the L. Welch Pogue Award for Lifetime Achievement in Aviation by *Aviation Week*.

He served as President and CEO of Southwest Airlines from September 1981 through June 2001, and Executive Chair from March 1978 to May 2008.

Business Horizons: Welcome, Mr. Kelleher. To begin, would you please share what represents one of the biggest obstacles you have had to overcome in starting a business?

Herb Kelleher: I helped to start Southwest Airlines, but never anticipated having to work there full-time.

It so happened that we lost the guy we had hired to get Southwest Airlines off the ground, so I was called off the bench with splinters in my butt. I discovered—and many airline analysts wrote pieces about it—that a lawyer cannot be successful running a business. For the first 6 months on the job I subscribed entirely to that thesis; it took me a little while to find my way. One thing from my legal background which proved helpful is that when lawyers try cases, they get all fired up and gung-ho. For example, when a whole law firm is told to stay for 3 days and not go home to eat or sleep, everybody does it. As such, I was used to exceedingly expeditious action. I wondered why I couldn't improve Southwest Airlines' performance by at least 20%-25% in 1 year. I finally listened to a speech by one of those corporate gurus who said that if you as a corporate leader can improve a company of any size by 5%, you've accomplished a miracle. Having heard that, I was able to relax a little, and my blood pressure went from 180/120 to 120/60.

Can you cite an example of how your personal experience helped mold you into an entrepreneurial leader?

Since I was little, I've liked athletics, and athletics involves trying to win. I have always been very interested in trying to win; not that winning in itself is significant, but trying as hard as you can is. I think that has carried over a lot into my business and personal life. I've also always been a bit of an idealist, so I felt provoked and angry when the other airlines tried to warp our system of justice to prevent Southwest Airlines from entering the business, and then tried to put it out of business. In a sense, I felt like an angel of justice: I was going to demonstrate that they could not get away with that in America, and fortunately, they couldn't. Just to give you some perspective on that, when one of our cases went to the U.S. Circuit Court of Appeals, a federal judge said that our situation was the worst case of business harassment he had seen in his 30 years on the federal bench. That made me angry. I didn't want the other airlines' tactics to work. So, I would put in 48 straight hours at the office without leaving—literally 48 hours, sometimes more.

As other carriers have struggled, Southwest Airlines has persevered. To what do you attribute that?

I attribute it to charismatic leadership! No, I really attribute it to historicity, a sense of futurity, and innovative thinking. Historicity involves remembering that bad times have come in the past, and futurity entails understanding that they will come again in the future. The goal is to manage in the good times such that you're okay during the bad times. There is a tendency to become euphoric

when times are good: "What the heck, we can go buy \$20 million worth of that and \$40 million worth of something else." But the bad times always roll around again, so if a firm manages well during the good times, it can be in a position like Southwest Airlines was on September 11th, 2001, when the World Trade Center and the Pentagon were struck. For about 15 years prior, we had been expanding more than any other airline. We had the strongest balance sheet, proportionally the most liquidity, and the lowest cost per available seat mile in the airline industry. That position came as a direct result of the company having been managed from a perspective that bad times will come in one form or another, and we have to be ready for them.

Let me give you an example of what I am talking about regarding innovative thinking. Before the September 11th terrorist attacks, fuel prices were quite low. That is a danger in the airline industry. You know why? Because it deceives you. You rationalize, "Our costs per available seat mile aren't bad. We're doing a really good job on costs." In 1997 or 1998, I considered the situation and said "This is a mask. Low fuel prices are concealing the fact that we are getting sloppy and inefficient. Take the fuel costs out of the equation and see how the other costs are doing." Well, under the guise of low fuel costs, our other costs were going up rather substantially. At that point, we focused on cutting those. Remember, this was in 1998 when the airline industry as a whole was enjoying one of its greatest periods of prosperity. That is what I mean by thinking innovatively.

As your competitors have had the government step in to bail them out on multiple occasions, I imagine you have been gratified since Southwest Airlines has remained innovative and experienced significant success. Has there ever been a time when you found the situation frustrating, given the government has essentially perpetuated your competitors?

First of all, let me give you a philosophic approach to that: Chapter 11 and government support are a refutation of the system of free enterprise, whereby supply and demand are supposed to freely rise and fall in relation to one another. The European carriers do not have Chapter 11 to fall back on; if they run out of money, they're done. The United States has Chapter 11 as a safety net, not just for the airline industry but for a lot of businesses. I know business people who make decisions based on that. They say, "What's the worst that can happen? I can always file for Chapter 11. I can scalp my creditors, get concessions from my employees, and take away all of the value from my shareholders, but guess what? The institution will still be there and I will still be there." That mindset and behavior is a refutation of

the free enterprise system, and I think more discipline in that regard might be needed. That would, in turn, force some companies to be more innovative.

For instance, before the bankruptcy lawyers lobbied the U.S. Congress to change bankruptcy law, corporations used to be able to file once every 5 years; if you filed for bankruptcy, you had to wait 5 years before you could file again. Today, it can be 5 days! The 5 year delay implied that businesses either had to make changes to save themselves, or they'd be gone. That's not the case now. I would love to see reintroduction of the 5 year minimum in order to stop companies from filing for bankruptcy every Tuesday.

The government-guaranteed loan program has clearly perpetuated a lot of the carriers that would otherwise not be in existence, and airlines are hard to kill. I analogize it to trying to down an elephant with a pencil: you have to stab it about 106 million times before it begins to feel the effect. Pan Am went on for 15 years; it was sort of the walking dead. TWA limped along—three bankruptcies. Eastern Airlines was in the same situation. It's kind of hard to knock an airline off. In respect to the health of the airline industry, if anybody thinks it is significant to our nation, we need to restrain the opportunities given to companies which struggle year in and year out such that the airlines are forced to institute corporate innovation to ensure their viability.

Regarding the government, it's unbelievable to me how the airline industry is taxed to death. I think this is a hangover from days gone by when everybody thought that only rich people flew. But I am not talking about income taxes; I am not talking about ad valorem taxes—throw those out. I am talking about the fact that federally authorized and imposed fees constitute about 26% of each fare that we charge. That's higher than the taxes imposed on both liquor and cigarettes, so that's a triple whammy for me; singlehandedly, I am supporting Medicare and Medicaid! All joking aside, I think we need reform from the taxation aspect. I don't know whether or not the average customer thinks paying 26%—a higher rate than the "sin" taxes of alcohol and tobacco products—of each ticket over and above all of the other taxes they pay is a little high. I didn't know it was a sin to fly; perhaps it is. Overall, I'd like to see relief in government taxation of the airline industry and restriction of Chapter 11 bankruptcy.

How do you reconcile providing low fares with the goal of providing large returns to your shareholders?

There's no opposition between the two: offering low fares provides the largest return to our shareholders. Fortunately, we were sufficiently innova-

tive—or intoxicated!—to realize that before we started Southwest Airlines. We charged the lowest fares in the airline industry; just look at the Department of Transportation (DOT) fare report. In its 30th anniversary issue, *Money* magazine featured an article that said our business model belongs in the Ripley's Believe it or Not category, because the company which has produced the highest return to shareholders over the last 30 years is an airline: Southwest Airlines. Charge low fares, get more people to fly, get them to fly more often, and you will produce the best return to shareholders. Low fares and high shareholder returns are not in conflict with one another in any way, shape, or form. You just have to keep your costs low. Of course, an airline could charge low fares and operate with high costs, but that wouldn't be a good idea.

What are the critical elements on which innovative companies should focus?

I think some of the critical elements are to remain outward looking, to preserve alacrity, and to stay loose. First, companies should maintain an external focus. Rather than gazing inward and admiring your own navel—no matter how pretty and lint-free it might be—you must look outward. After all, competitors represent great white sharks: they'll eat your liver if you don't continue to innovate. Second, firms should preserve their alacrity and be able to strike like a puma under any circumstances. This quick response capability is often lost by companies as time passes. One way to keep this skill involves fostering a fluid exchange of ideas, whereby everyone feels free to get the information they need without having to dig through multiple layers. Ideas should be able to easily circulate up, down, and around. I think that is extremely important. In this scenario, paperwork is the enemy. Yes, you need it, but you constantly have to fight to keep the volume down and simplify the information so that people can understand it readily. I also believe you need to exalt the people who come up with new ideas; they must be thanked and toasted and lionized for the ideas they've provided, and which have been productive and constructive. Finally, if a firm is interested in remaining entrepreneurial as it grows, staying loose is probably the bottom line. Stay loose. Don't be afraid to do the Macarena or anything else, and make your people feel absolutely free to communicate anything and everything with you in any way they prefer. And be quick; be quick.

What are some of the biggest obstacles to remaining innovative that you have had to address as Southwest Airlines has grown?

First of all, if the company is doing well, there is a tendency to grow too fast. When this happens, you outstrip the strength of your balance sheet and you outstrip the capacity of your personnel in the process. Since Southwest Airlines was growing very fast at one point, if we were to avoid that temptation, we needed to set limits on our growth. Above all, we needed a financial limit. We decided that no matter how attractive expansion looked, we were going to maintain the strongest balance sheet, the most liquidity, and the only investment grade rating in the airline industry. That measure was taken to hedge our bets against the inevitable bad times I mentioned earlier. On top of this, though, we also decided that we had to institute another limitation on expansion, one which is cultural in nature. We simply cannot increase our staff by 10% per year and expect to maintain the same kind of environment and culture we have, and that is important to us.

The issue is not just change, but the pace of change. Sometimes you have to slow things down. A company can have several good changes it wants to institute and which it wants to occur, but we at Southwest Airlines realized that we couldn't dump six of those changes on our people in a 1 year time period. Instead, we considered introducing them in 2 years: three in 1 year and three in the other. If you change too much too quickly, it tends to upset people and make them insecure. In order to get the most out of innovation, it must be managed, and this involves protecting your employees from too much at once. Southwest Airlines made a conscious decision regarding cultural limitation on expansion, because we realized we couldn't keep doing business as usual if we brought in tens of thousands of new people each year.

Given the importance that Southwest Airlines places on its people, how have you ensured that the flow of ideas has continued as the company has matured?

We have a rule at Southwest Airlines: An employee can send an idea to anyone at any time. They can convey it orally, put it in writing; it does not matter who it is. Responses are sent within 1 week. We want to show respect for the fact that they cared enough to submit that idea. In addition, a simple "no" is unacceptable; that is just an exercise of power and can be invoked very irrationally. If we say "no" to

your idea, you are likely to receive a page and a half explaining exactly why we don't think it will work at that point in time. This process keeps ideas coming from people, because they do not feel as if they have been spurned as a consequence of being ignored or just being told "no." If you consistently turn down ideas, you won't get any more. A venture capitalist can entertain twenty ideas for every one that eventuates into something worthwhile, so within the company we try to do the same thing: keep the ideas coming. Otherwise, you end up curtailing innovation.

Do you use suggestion boxes throughout the company to encourage employee feedback?

A suggestion box at Southwest Airlines signals failure as a manager; you should be communicating with your people orally on a personal basis and on a regular basis. A suggestion box is a way of fending them off: you don't have to see them, you don't have to discuss anything with them. We actually don't allow suggestion boxes, as they're the equivalent of putting a moat around the management castle. We teach each of our managers to sit down at least once a week with all of the people who work for them, so if they have any suggestions, they can make them in person.

What keeps you innovative?

Wild Turkey and cigarettes—I could not do it without them! Seriously, it is my passion for the airline industry and particularly for the job security of our people. Plus, I enjoy the heck out of it. I like change; change doesn't daunt me at all. If you have that kind of personality in the airline industry, it is very exciting because change occurs kaleidoscopically within a very short period of time. People will call me and say, "Herb, I've been here at Southwest for 10 years, and I'm burned out." And I say, "Well, I'm really sorry to hear that." Then I wait about 6 months and they call again: "Can I come back? I'm really bored with the job I have now!"

I think if your vocation is also your avocation, you are in good shape. If you have that kind of passion for it, innovation will follow.

Note: Adapted from the Distinguished Entrepreneur-in-Residence visit (Kelley School of Business, Indiana University) on February 8, 2008.