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## **U.S. Airline Industry Update and Perspective on the Implications of Forecast Uncertainty**

John P. Heimlich, Vice President & Chief Economist  
FAA-NEXTOR: “Global Challenges to Improve Air Navigation Performance”  
Feb. 11, 2015 Workshop at Asilomar

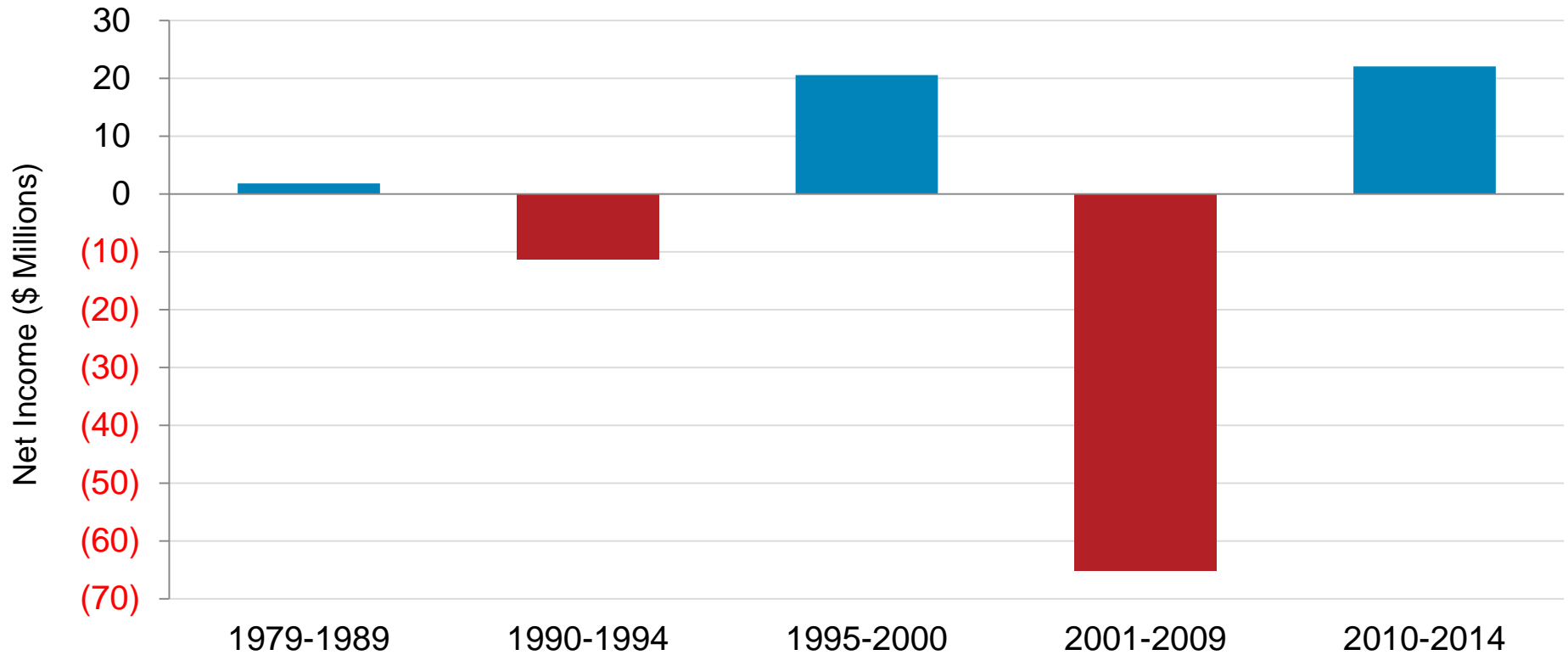
# Contents

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- Where We've Been
- Where We Are Now
- Ways to *Think* About Where We *Might* Be Headed



# In the Deregulated Period, U.S. Airline “Earnings” Have Been Cyclical and Volatile

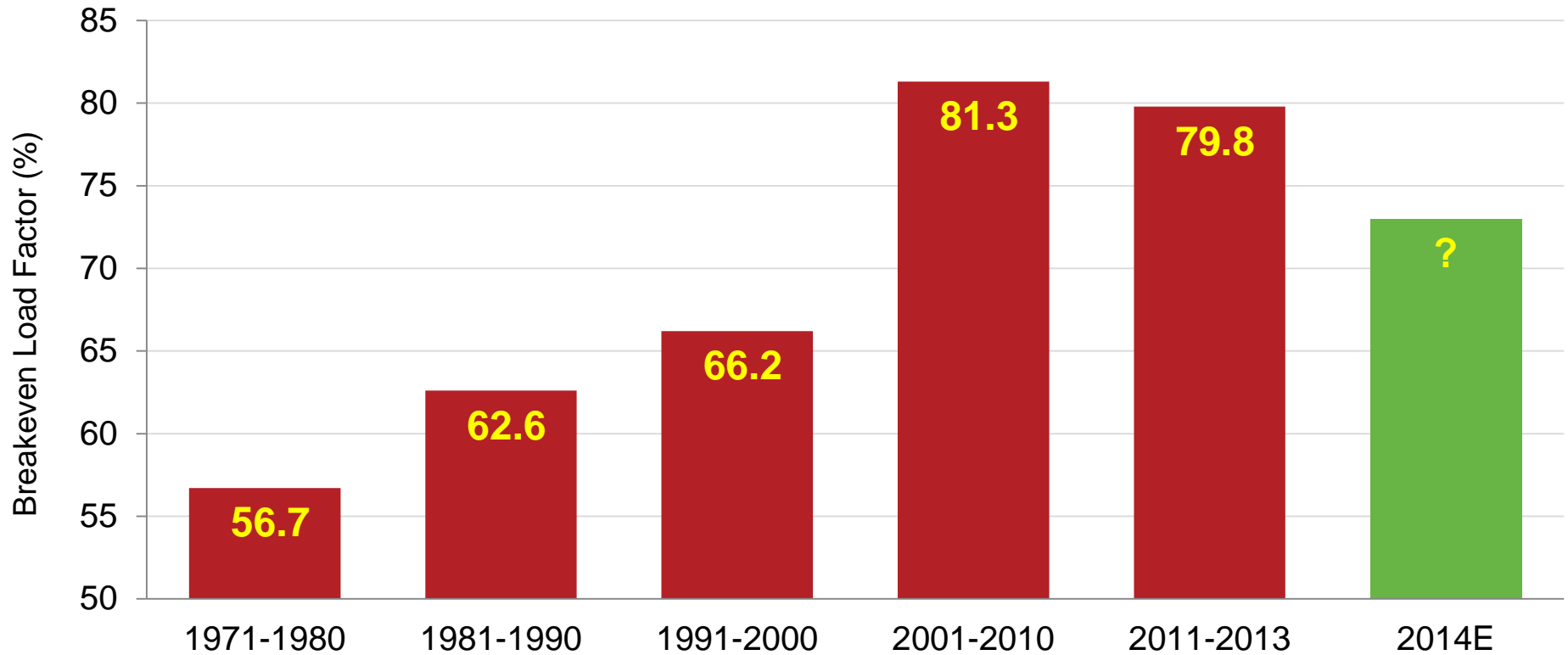


Source: A4A Passenger Airline Cost Index



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**This Decade, U.S. Airline Flights Need to Be ~80 Percent Full to Avoid Losing Money**  
Over Multiple Decades, the Rising Costs of Running an Airline – Without a Commensurate Increase in Fares – Have Meant That Airlines Have *Had* to Fill More Seats to *Break Even*



Source: A4A Passenger Airline Cost Index

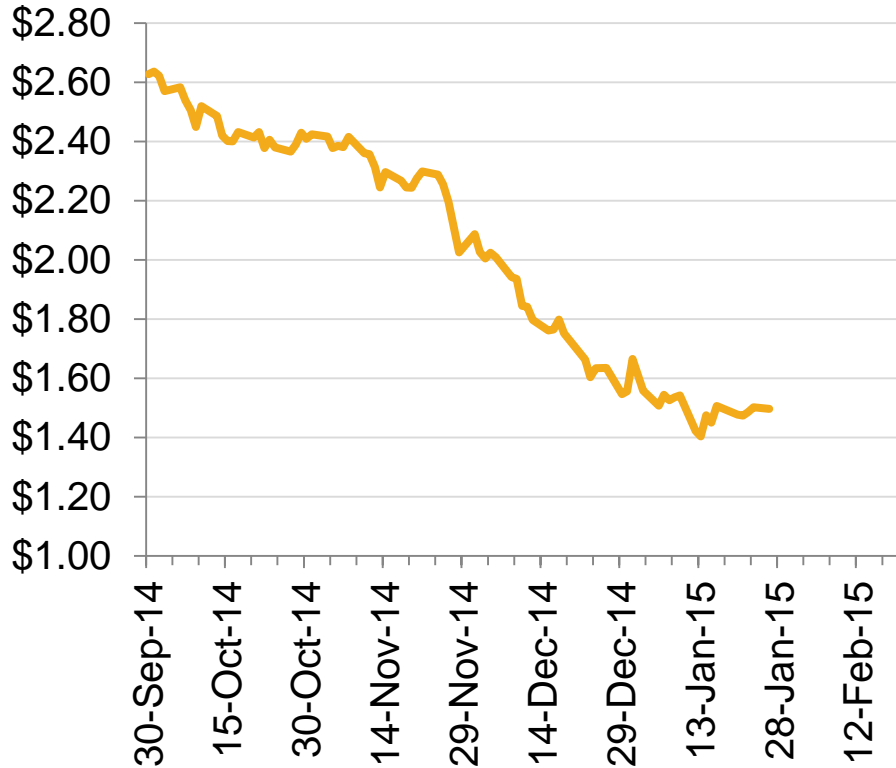


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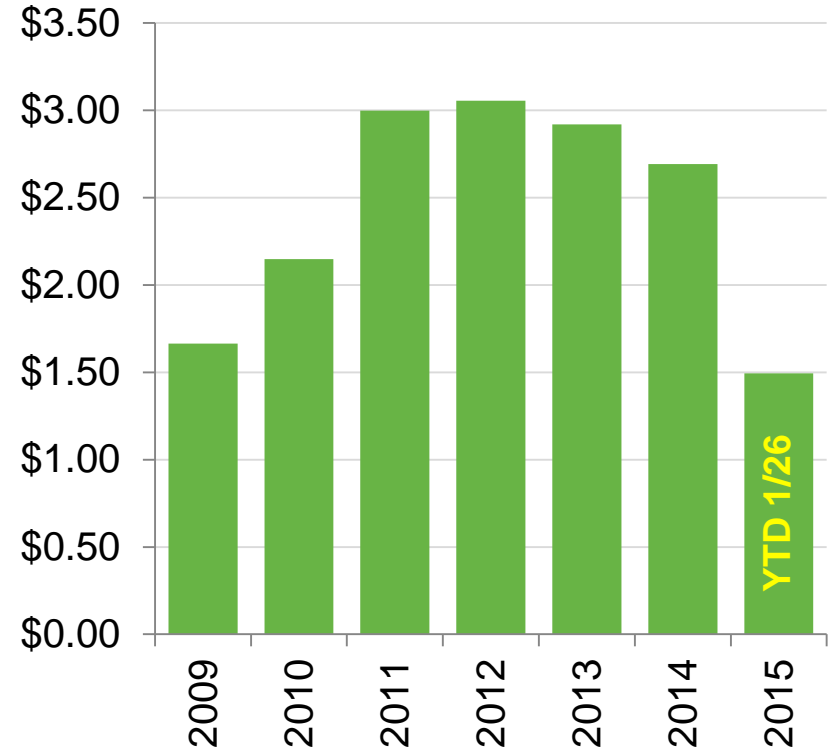
# Jet-Fuel Spot Prices Fell in 2014, Boosting Seats, Wages and Product Investment

Every Penny per Gallon per Year Equates to \$190M in Annual Fuel Expenses

Daily Spot Price per Gallon (U.S. Gulf)



Annual Spot Price per Gallon (U.S. Gulf)

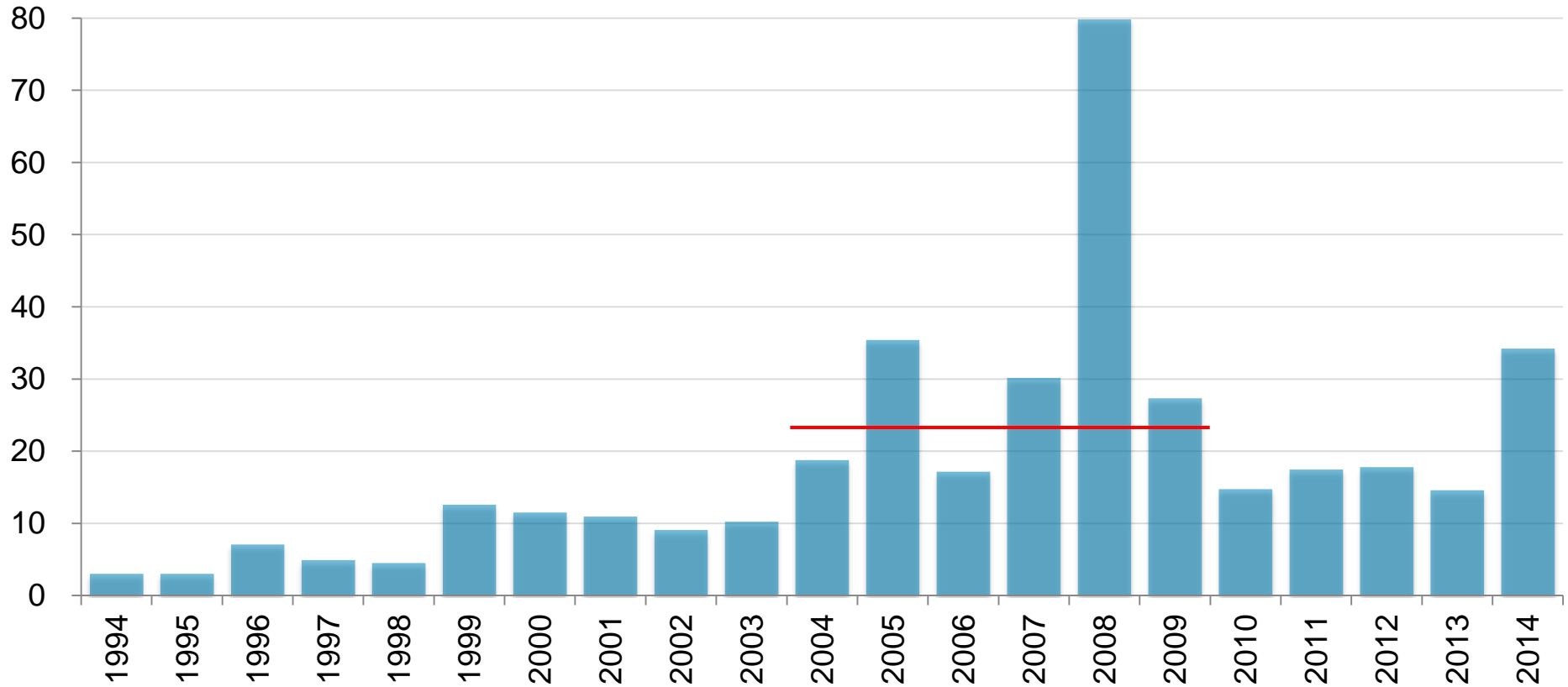


Source: A4A and Energy Information Administration (U.S. Gulf Coast)



# After Its Post-2008 Decline, Jet Fuel Price Volatility Returned in 2014

## Annual Standard Deviation of U.S. Jet Fuel Spot Price (Cents per Gallon)



Source: U.S. Energy Information Administration

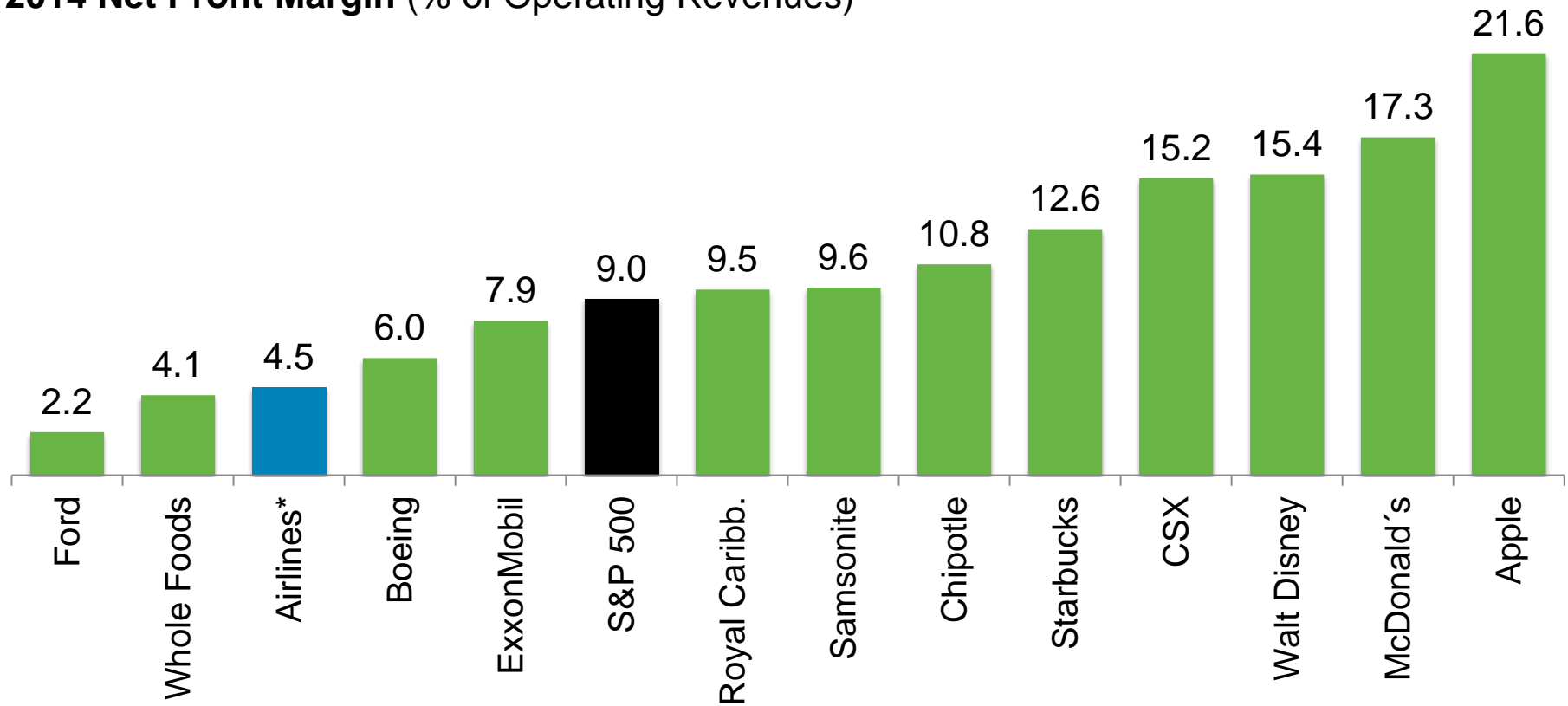


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# The Airline Industry Remains a Low-Margin Business, Lagging S&P 500 Average

For Every Dollar of Revenue Collected, U.S. Airlines Keeping a Nickels as Profit

2014 Net Profit Margin (% of Operating Revenues)



\* A4A analysis of reports by Alaska, Allegiant, American, Delta, Hawaiian, JetBlue, Southwest and United  
Sources: Standard & Poor's and company SEC filings; S&P is trailing twelve months



# After Years of Staggering Losses, U.S. Airlines\* Are Tackling the Mountain of Debt

"...it would be unreasonable to assume that all airline risks have just disappeared... [T]he business model requires a large cushion of cash and significant reinvestment."

Alexander MacLennan  
The Motley Fool  
Feb. 3, 2014

Total Debt\* (\$ Billions)



\* SEC filings of Alaska, Allegiant, American, Delta, Hawaiian, JetBlue, Southwest, Spirit and United; includes capitalized operating leases at 7x annual aircraft rents



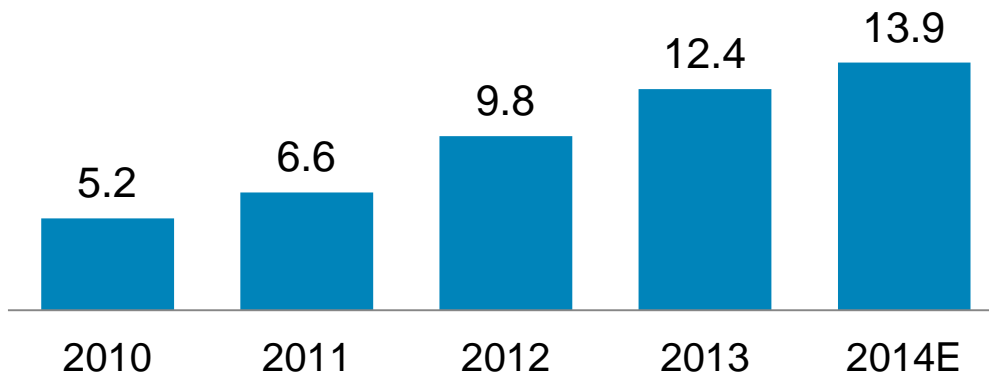
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# Improving Finances Enabling Significant Reinvestment in Customer Experience

## Airline Capital Spending Exceeding \$1 Billion per Month – Highest in 13 Years

### U.S. Airline\* Capital Expenditures (\$ Billions)



- » Aircraft (**317 deliveries in 2014; 367 in 2015**)
- » Premium seats, new aircraft interiors
- » Ground equipment, loading bridges
- » Airport lounges and gate amenities
- » Bag carousels, carts, scanners
- » In-flight entertainment and Wi-Fi
- » Computers, kiosks, mobile technology



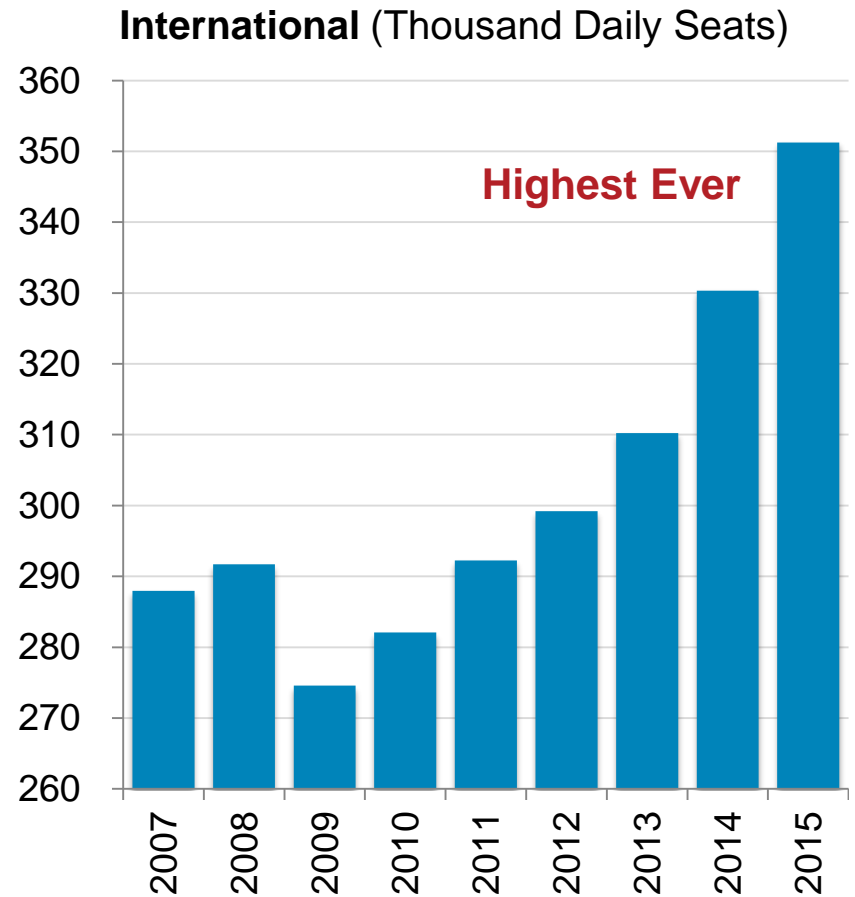
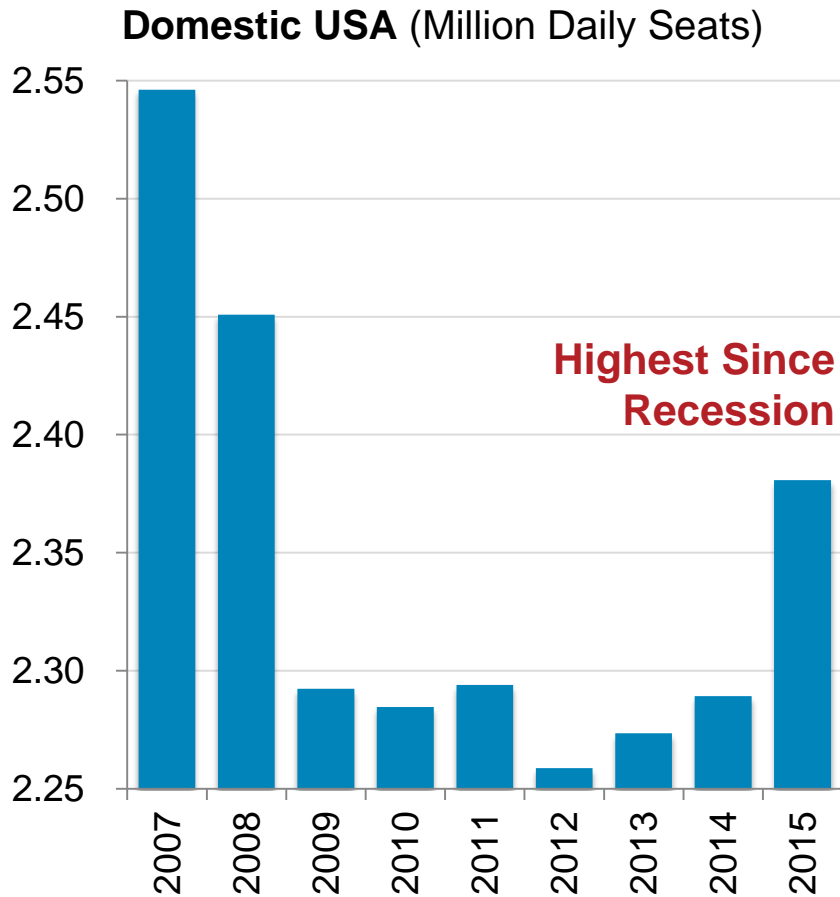
\* SEC filings of Alaska, Allegiant, American, Delta, Hawaiian, JetBlue, Southwest, Spirit and United



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# As Airlines Generate Normal Returns on Capital, Customers Are Seeing More Seats

Domestic Supply Is at Highest Point in Seven Years; International Supply at All-Time High



Source: Innovata (via Diio Mi) published schedules as of Feb. 6, 2015 for all airlines providing scheduled passenger service from U.S. airports to all destinations

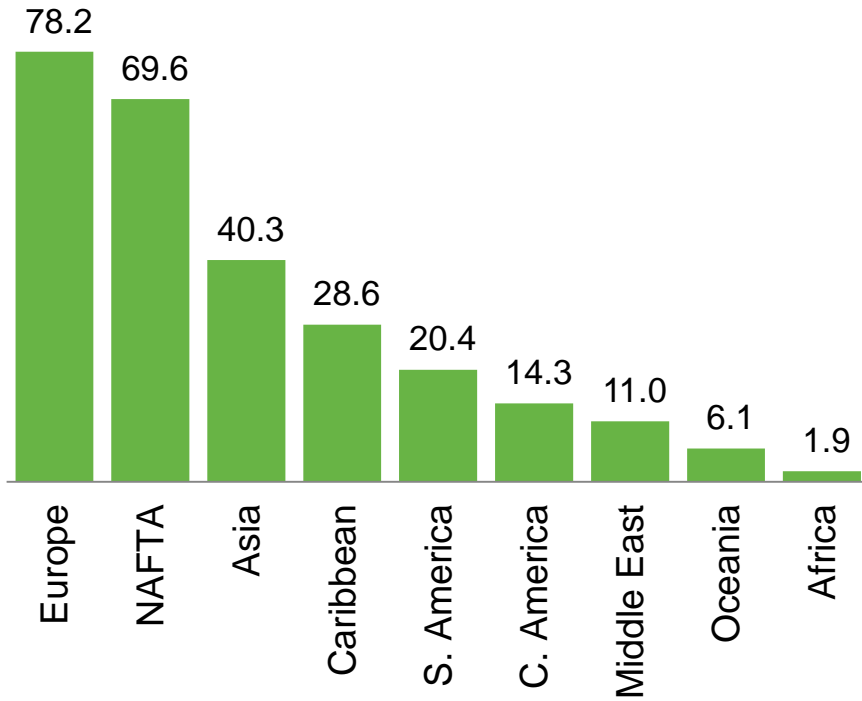


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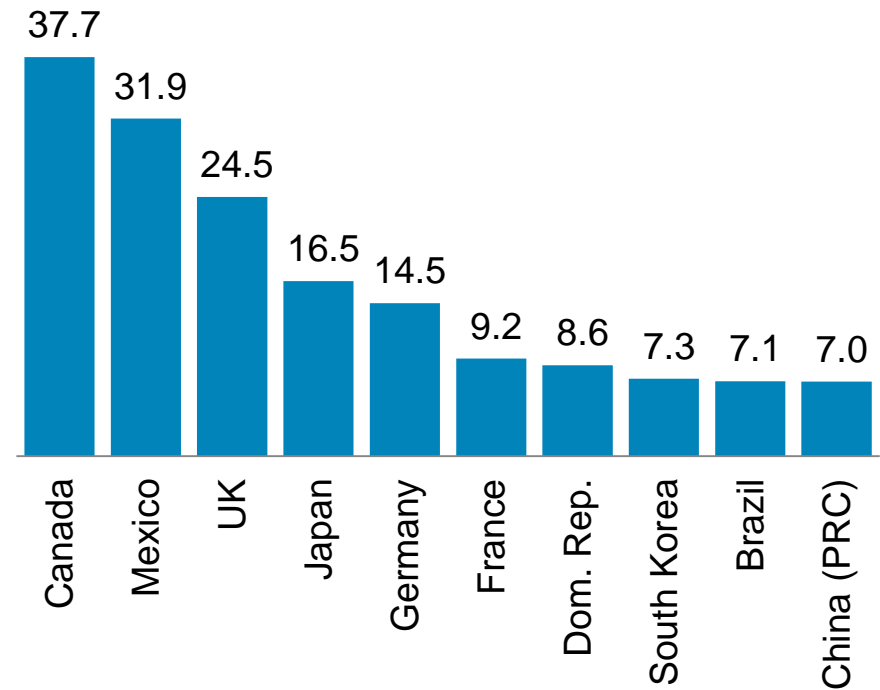
# International Air Travelers to/from USA Reached a Record 197.3 Million in 2014

Up 6.5 Percent from 2013; U.S.-Europe Led Overseas Traffic at ~78K Per Day Each Way

**Foreign Gateways to/from USA, 2014**  
Average Daily Passengers (000) Each Way



**Top 10 Country Gateways to/from USA, 2014**  
Average Daily Passengers (000) Each Way




Source: Department of Commerce (National Travel & Tourism Office) and DHS Advance Passenger Information System (APIS)



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# Airline industry pours millions into new terminals

 **Charisse Jones,** 10:03 a.m. EDT March 17, 2014



(Photo: Reed Saxon, AP)

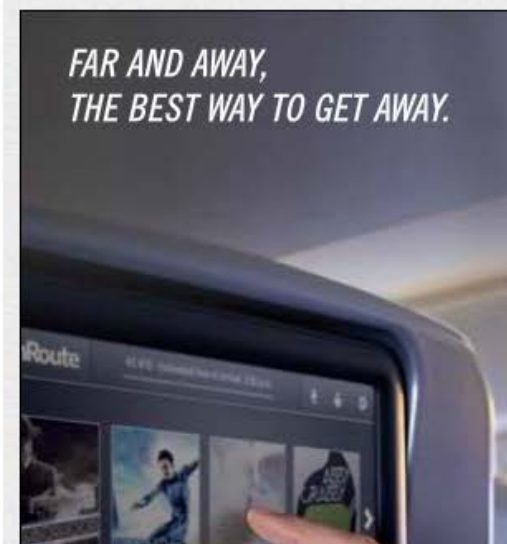
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For business travelers, crisscrossing the country or the globe, airport terminals can be akin to a second home.

Those beehives where the flying public gets boarding passes, checks bags and waits for flights are also the first and final glimpse a traveler has of a

city, a business hub for concessionaires and — depending on the experience — a potentially key factor in whether a passenger boards a jet in a tranquil or testy mood.

Now, airlines and airports are spending hundreds of millions of dollars building and revamping airport terminals across the U.S., from putting in work stations and lounge-like seating to adding Wi-Fi to transforming the building's exteriors into architectural standouts



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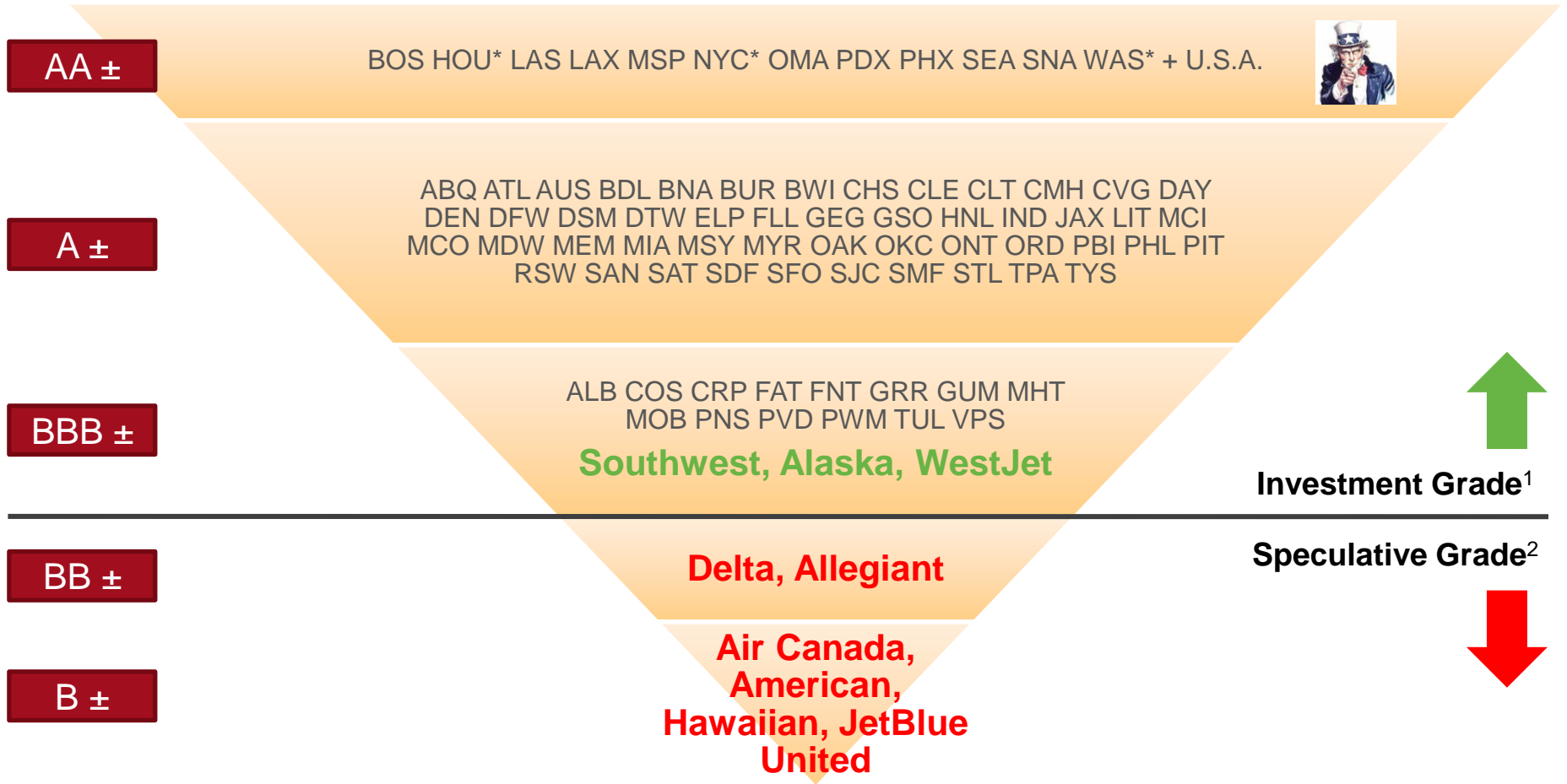
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# Unlike Airports and USG, North American Airline Creditworthiness Remains Deficient



<sup>1</sup> Describes issuers with relatively high levels of creditworthiness and credit quality

<sup>2</sup> Describes issuers with ability to repay but facing significant uncertainties, such as adverse business or financial circumstances that could affect credit risk

Source: Standard and Poor's

\* HOU = HOU/IAH; NYC = EWR/JFK/LGA; WAS=DCA/IAD



## U.S. Airlines Intensely Focused on Several Near-Term Objectives

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- Reducing debt
- Returning cash to shareholders (dividends, stock buybacks, ROIC/EPS)
- Shoring up pensions (or comparable underfunded retirement liabilities)
- Increasing employee wages and benefits
- Renewing fleets and improving the product (at home, airport and in-flight)
  - Enhance customer experience
  - Increase operational reliability
  - Achieve voluntary environmental targets
- Restoring/increasing, in a return-justified manner, air service levels (capacity)

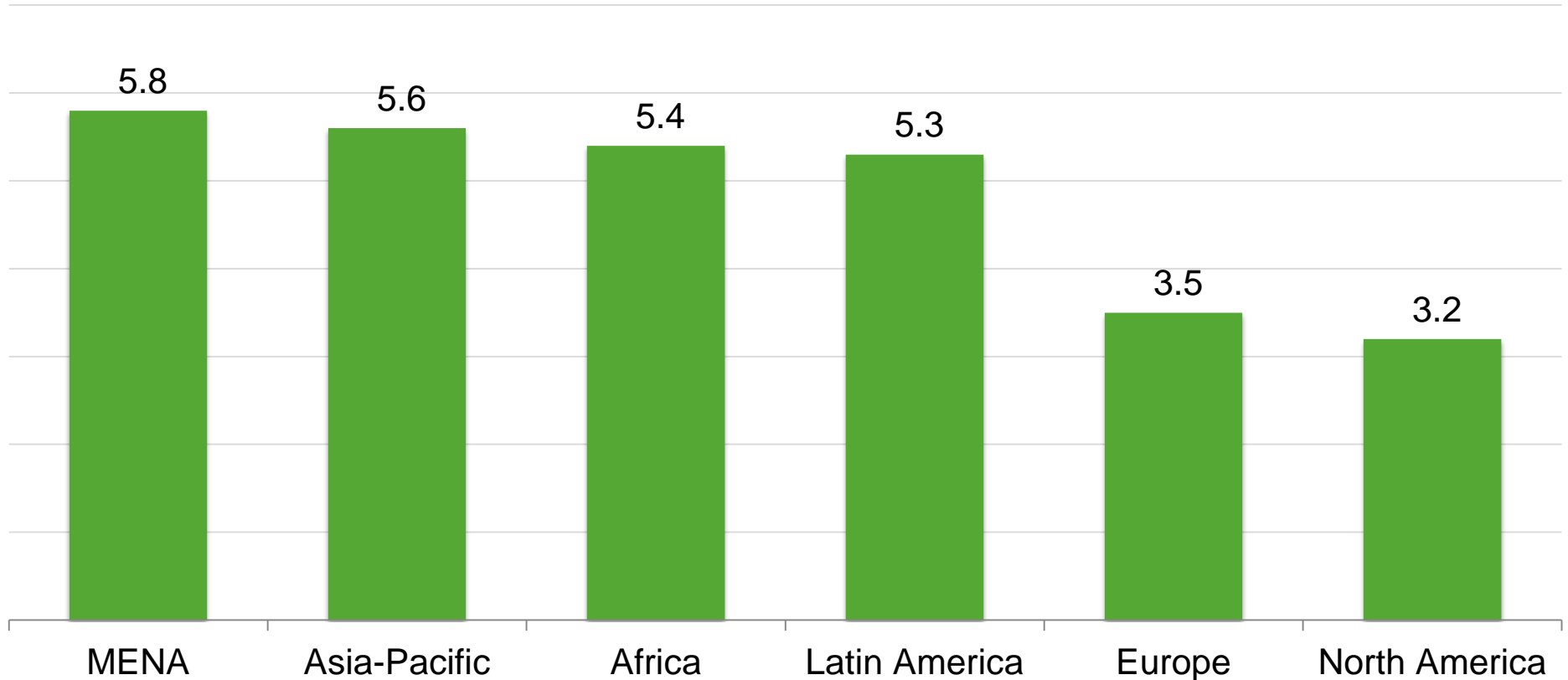
**It's not about capacity discipline; it's about balance sheet discipline.**



# Relatively Speaking, Airports in Europe and North America Are Mature

## Middle East, Africa, Asia-Pacific and Latin America Expected to Lead 20-Year Growth

Projected Average Annual Growth in Air Passengers: 2014-2033/2034



Source: ICF International, using average of IATA, Airbus and Boeing forecasts



## But... Be Careful Who's Listening, or Tweeting

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- “A rocket will never be able to leave the Earth’s atmosphere.”
- “Who the hell wants to hear actors talk?”
- “There will never be a bigger plane built.”
- “We don’t like their sound, and guitar music is on the way out.”
- “The concept is interesting and well-formed, but in order to earn better than a ‘C,’ the idea must be feasible.”
- “With over 50 foreign cars already on sale here, the Japanese auto industry isn’t likely to carve out a big slice of the U.S. market.”
- “There’s no chance that the iPhone is going to get any significant market share.”
- “The Federal Reserve is currently not forecasting a recession.”





# Whether It's Economy or the Weather, Forecasts Matter

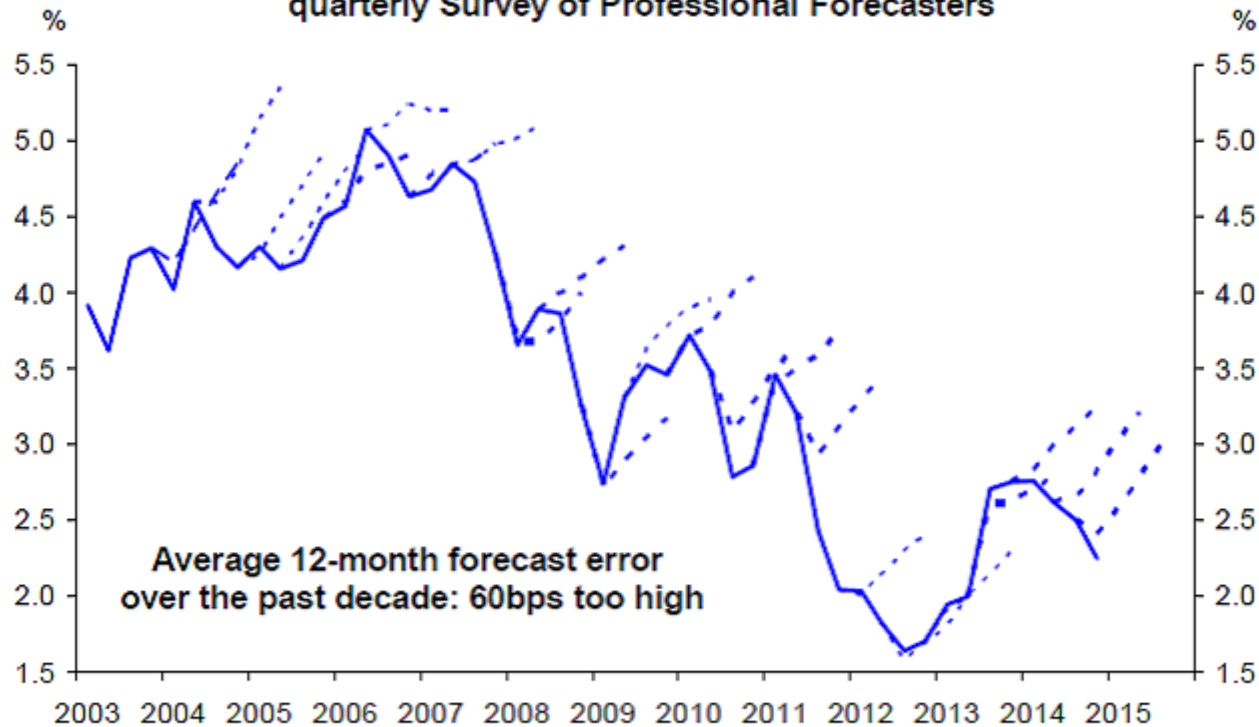


# Overreliance on *Baseline* Forecasts Can Be Hazardous to Your Wealth

Wall Street economists have been consistently wrong in their forecasts for the ten-year rate over the past decade



Actual 10y rate and forecasts for the 10y rate from the Fed's quarterly Survey of Professional Forecasters



Source: FRB, FRBPHIL, Haver Analytics, DB Global Markets Research

Deutsche Bank Research

Torsten Slok, [torsten.slok@db.com](mailto:torsten.slok@db.com) +1 212 250-2155

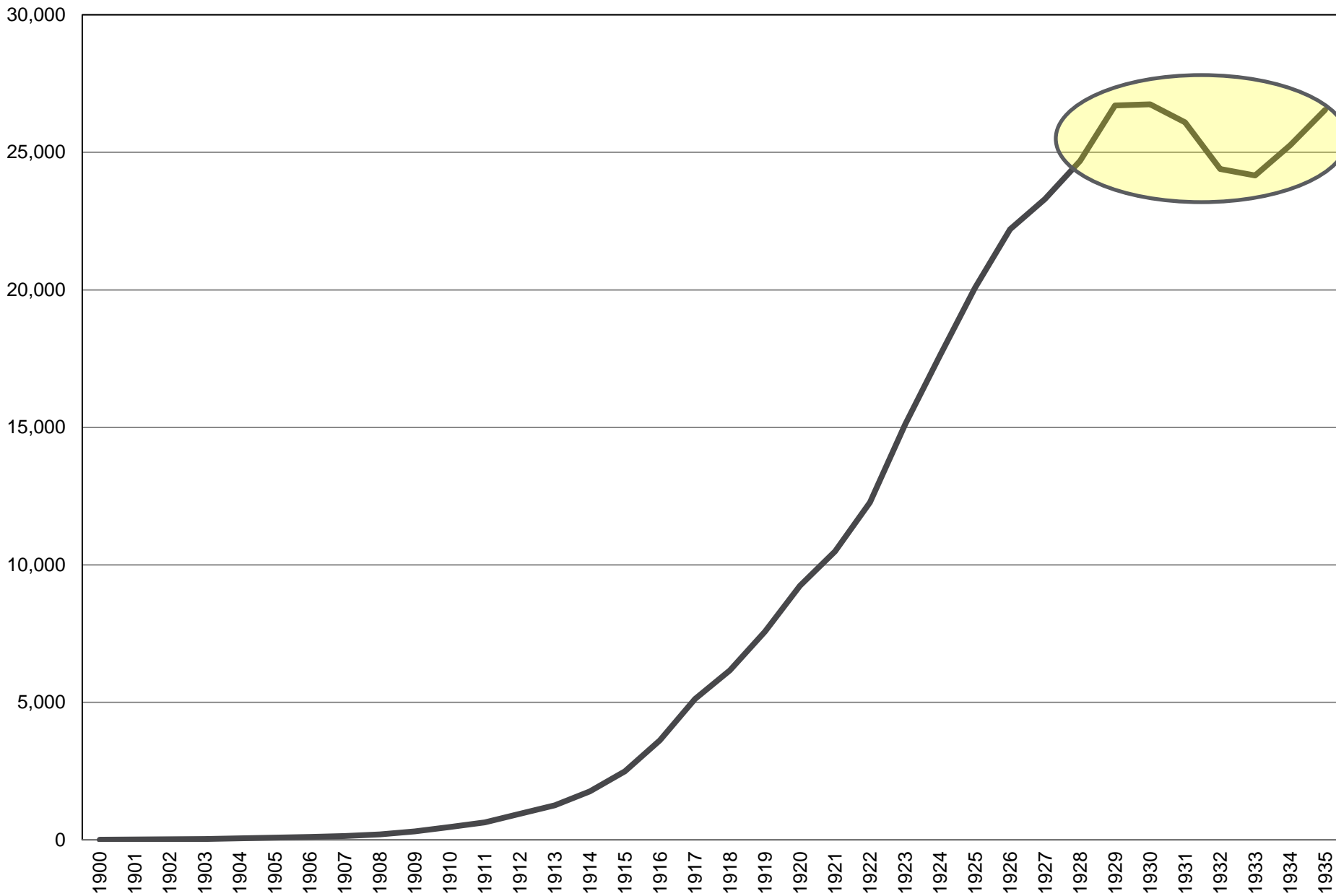
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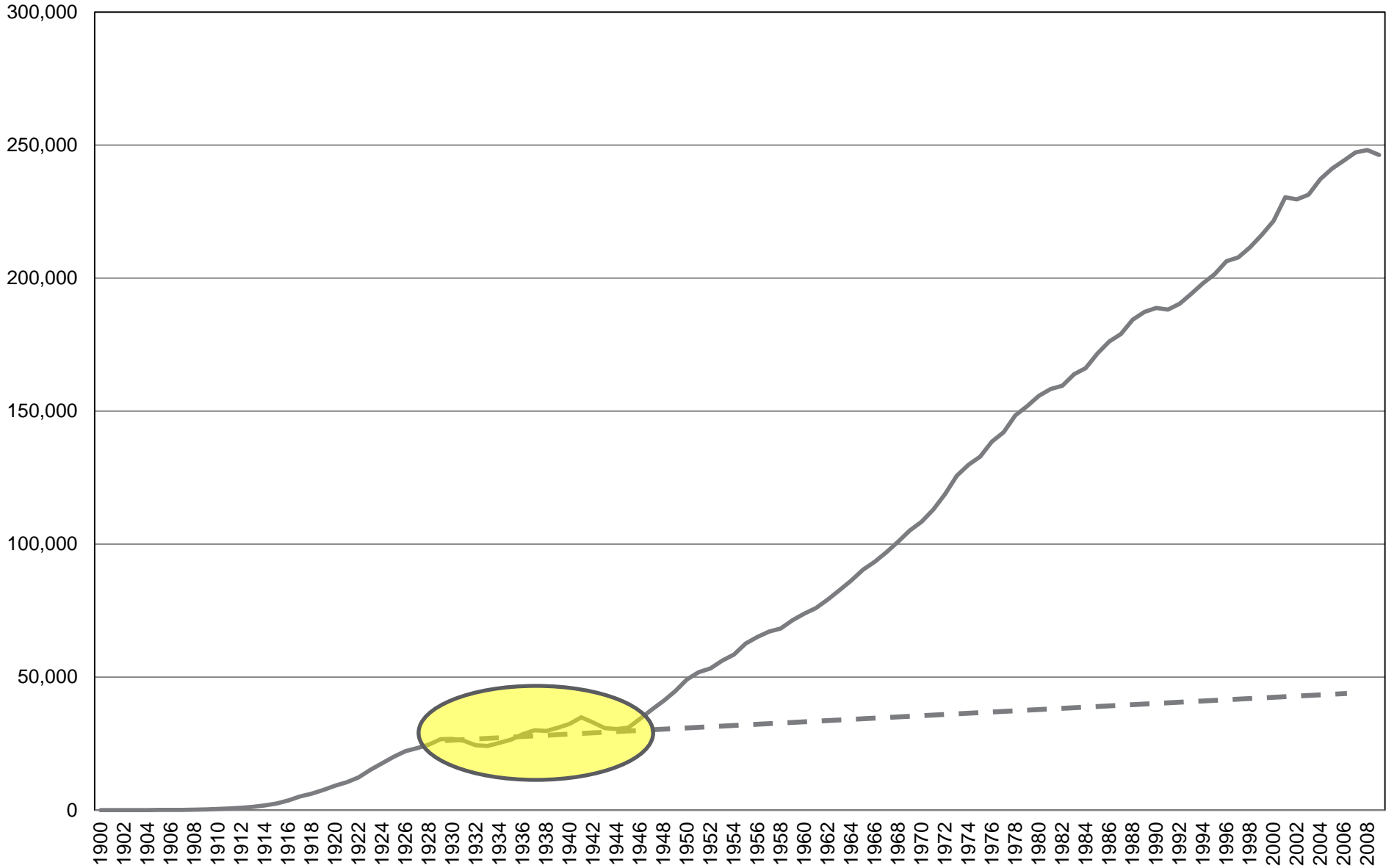


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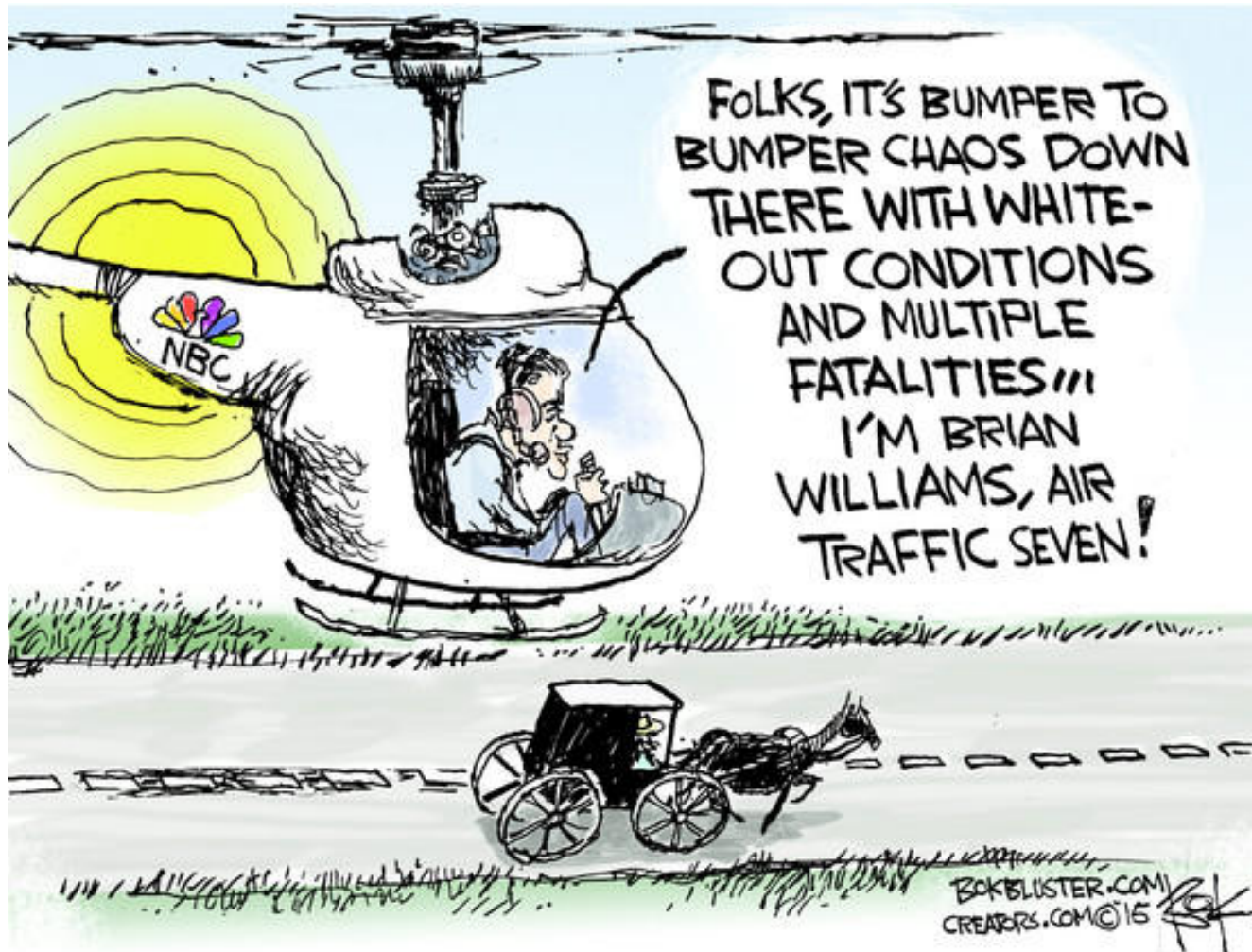
# U.S. Vehicle Registrations: 1900-1935



# U.S. Vehicle Registrations: 1900-2009



## One's View on Traffic Levels Might Differ Based on Where One "Sits"



## Musings or Predictions Oft Heard Through the Grapevine

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- “Pricing power is here to stay”
- “Cycles are no more”
- “We’re on a path of steady growth”
- “Fuel prices are down...forever”
- “Domestic is where it’s at”
- “Carriers are making lots of money”
- “Equity investors are taking note of the airline space”

**Memories can be short – and financial awareness lacking.**



# What Are Public Policy Goals and Expectations?

## Are Stakeholder Interests Aligned or Conflicting?

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### Stakeholders: Customers, Employees, Investors + Economy and Planet Earth

- Safety comes first, of course
- More air service and economic growth but reduced noise and emissions
- More air service but lowest possible fares/fees
- Maximize air service and minimize price, but take good care of employees
- Attractive price but world-caliber (globally competitive) international product
- Hub cities or small communities, or both?
- Strong airlines or strong non-airline members of the value chain?
- Do American investors matter? Should creating American wealth and luring equity capital to grow and enhance the business be considered?



## Considerations for Forecasting and NAS Planning

Sometimes asking the right questions is more important than having all the answers

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- Public policy goals and expectations – can they compatibility promote U.S. consumer and economic interests, as seen in some parts of the world?
- What role do taxation and regulation play in promoting or curbing growth of air service in terms of quantity and quality?
- Role of social media – on and off flight – does it stimulate more demand?
- Will aviation community be able to meet customer expectations for automation?
- Foreign ownership – will pressure build for even lower barriers to entry? Will we see partial or full relaxation in 20-year horizon? NAFTA or NAFTA-lite first?
- Pilot pool – will we see one-man cockpits? Military, then air cargo, then...? What is general labor pool mobility in aviation? Will wages get out of hand?





## Considerations for Forecasting and NAS Planning (Cont'd)

Sometimes asking the right questions is more important than having all the answers

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- Aircraft range – more point-to-point and/or multiplex capability, with implications for U.S. and non-U.S. airports/airspace as well as Customs/Immigration
  - BA @ LHR-AUS/LAS/SAN, Norwegian @ ARN/OSL-SJC, JAL @ NRT-SAN, Korean @ ICN-LAS, ANA @ NRT-SJC, UA @ SFO-CTU, Virgin Atlantic @ LGW/MAN-LAS, Avianca/Condor, NAI @ FLL
- New hubs or larger international widebodies at non-traditional U.S. gateways
  - AA expanding DFW-Asia, DL @ SEA, multiple Asian carriers at BOS, QF @ SYD-DFW
- Small-community service: if long-run fuel prices stay high, will OEMs produce an economical small aircraft? If not, how might market (and policymakers) respond?
- Will ultra-low-cost carriers (ULCCs) one day become the largest domestic carriers?

**Lots to think about; let's prepare for a range of possibilities.**

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