STATE OF THE AIRLINE INDUSTRY

North American Airlines Profitable in 2010, But Fuel Spike Clouds Further Recovery

By ALPA's Economic and Financial Analysis Department Staff

What's the economy doing? And how will it affect ALPA members? ALPA's Economic and Financial Analysis Department examines the current state of the industry. The following is its assessment as of March 11.

The global economic recession of 2009, resulting in weak passenger demand and billions of dollars in losses, was a distant memory in 2010. Passengers returned, fuel and other costs were mostly contained, and airlines worldwide were able to earn more than $16 billion in profits. That strong performance proved to be a much-needed boost for airlines and pushed many to think about the expansion phase of the industry cycle.

The U.S. airline industry contributed to a major part of that turnaround as mainline airlines earned more than $4 billion in pre-tax profits in 2010, an $8 billion swing from 2009. With the strong performance of 2010, all indicators pointed to a continued recovery in 2011, with many airlines looking for modest growth and free cash flow to pay down debt. Unfortunately, early 2011 brought a return of rapidly rising fuel prices that, if sustained, will likely put significant pressure on the industry and cause airlines to reassess their plans.

Overall analysis—modest recovery takes hold

A thorough analysis of the airline industry must begin with a review of the economy as a whole. Although the airline industry is more susceptible to certain external events (increases in fuel prices, terrorism, global health concerns, etc.) than other industries, the global and U.S. economies have a very significant effect on airline performance. Fortunately, most economic indicators have shown modest improvement, which is expected to continue, if not improve, over the next 6 months.

The gross domestic product (GDP), which is often cited as the economic indicator that most closely correlates with airline revenues, has shown respectable improvement. Preliminary estimates are that the GDP grew at a rate of 2.8 percent in fourth quarter 2010, marking the 6th consecutive quarter of growth. Most economists are relatively optimistic and expect the U.S. GDP to continue to grow at 3 plus percent for the rest of the year and for inflation to remain contained, while estimates for Canada's GDP are somewhat lower with an expected average growth rate of 2.3 percent.

Factor #1: job market

While the GDP and some other indicators have been improving, one of the primary economic concerns of the past few years has been the lack of growth in the job market. Fortunately, as Chart 1 shows, the economy is finally starting to see some progress on the jobs front. The U.S. unemployment rate dropped to 8.9 percent in February 2011, down from 9 percent in January and 9.4 percent in December 2010. While the rate is expected to remain high for the foreseeable future, the downward trend in unemployment is expected to continue, with a forecast 2.1 million additional jobs created in 2011. Many of the recent additional jobs are coming from the private sector, which signals that businesses are starting to hire again and growth in income is expected. In Canada, there is similar progress on the job front, where the unemployment rate in January was 7.8 percent (much of 2010 was above 8 percent) and is forecast to decline slowly in 2011.

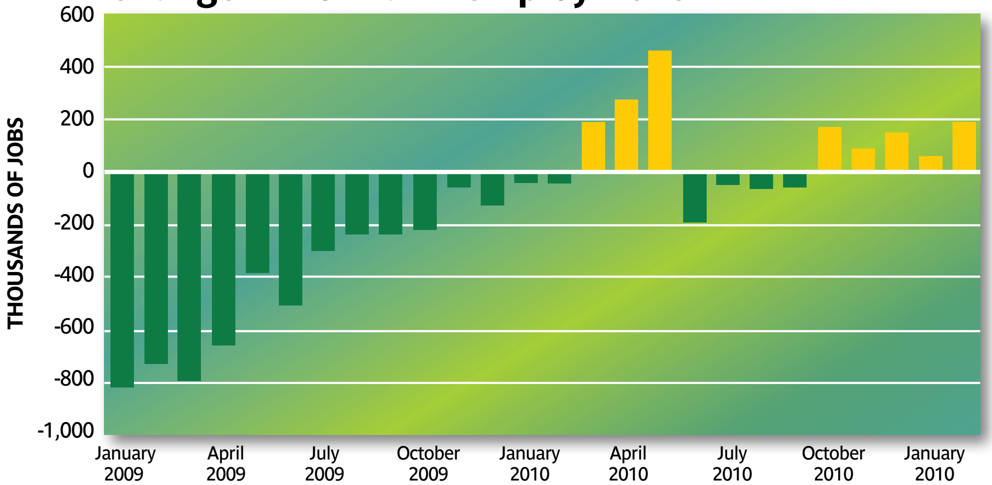
While much of the recent economic data have been pointing to recovery, there are some indicators and industries where problems persist. Housing, for example, has had a very bumpy road to recovery. In 2010, existing home sales fell 4.8 percent year-over-year, while new home sales were down 14.2 percent. Median existing home prices were unchanged from 2009, and prices are expected to continue falling in many markets due to a still-high number of foreclosures. Both housing and employment numbers are of concern to the airline industry as they translate directly to personal income levels and discretionary spending.

Factor #2: fuel

Fuel price volatility is another area of significant concern. While rising fuel prices result in higher fuel expenses, they can also have an effect on demand (revenue side). With consumers paying higher

CHART 1: ECONOMIC RECOVERY PICKING UP SPEED

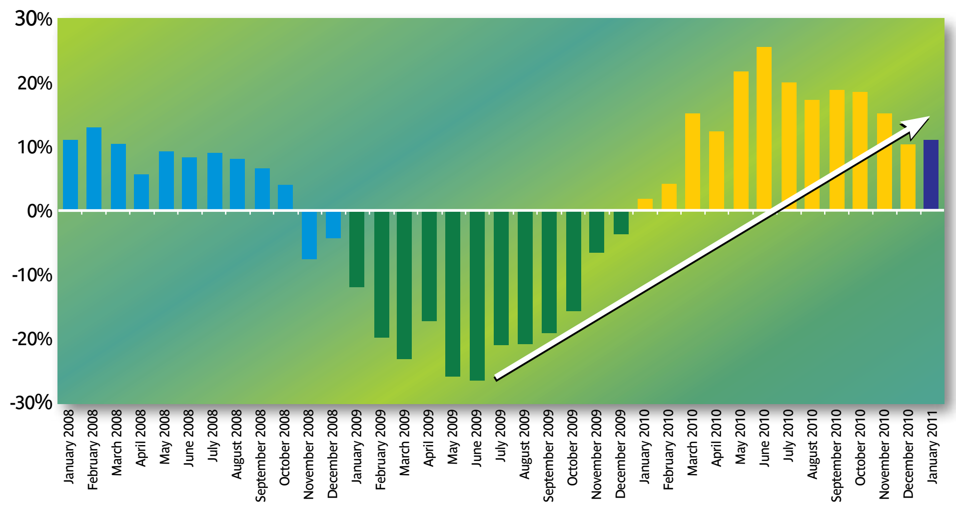
Change in non-farm employment



Source: BLS, Current Employment Statistics, Preliminary figures for January and February 2011

CHART 2: PASSENGER REVENUES FOR U.S. AIRLINES CONTINUE TO IMPROVE FROM 2009 LOWS

Total passenger revenue for U.S. airlines, year-over-year percentage change

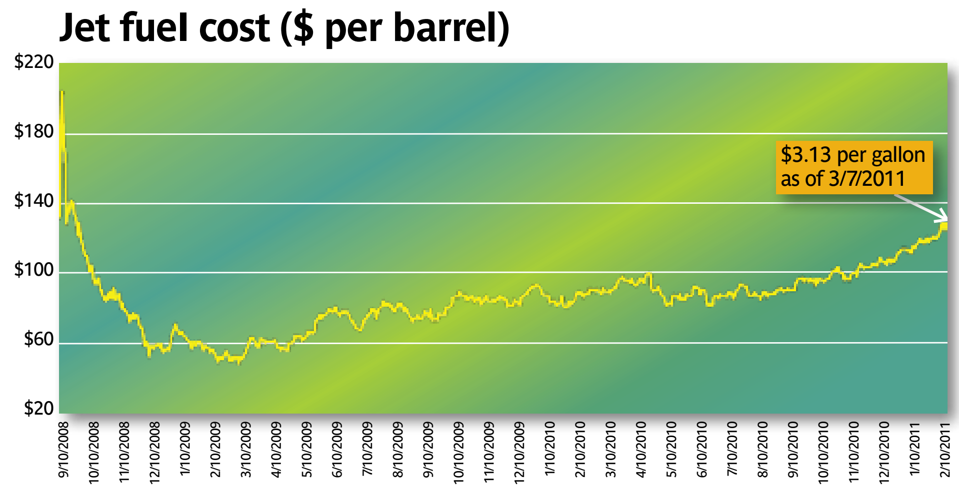


Source: ATA and E&FA calculations

prices at the gas pump or for home heating oil, they may have less disposable income to spend on other items. Compounding the problem is that rising fuel prices often lead to higher prices on necessity items such as food and clothing, which has a compounding effect on discretionary spending such as travel.

Despite some of these problems, the consensus is that the economy in North America is expected to continue to grow at a steady pace in 2011 and provide a good base for airlines to produce positive revenue results.

CHART 3: JET FUEL PRICES ARE BECOMING A VERY LARGE ISSUE AGAIN



Source: EIA (Gulf Coast Jet Fuel), Capital Group, LLCs

Passenger airline industry—2010 review

While the economy experienced modest growth in 2010, the passenger industry enjoyed a revenue recovery that greatly outpaced the economy. As Chart 2 shows, passenger revenues for U.S. airlines improved dramatically last year, partially because of the sharp declines in 2009. The upward trend has been continuing for 13 months now, as January 2011 domestic passenger revenues increased 9 percent from a year earlier and international revenues grew 16 percent.

The revenue recovery in 2010 was a function of several factors, including economic recovery and increasing corporate travel budgets. International revenues played a critical role in the turnaround as several major U.S. and Canadian airlines have shifted capacity to international markets (avoiding the hypercompetitive domestic markets). In addition, airlines continued expanding their revenue stream, as ancillary revenues (fees for checked bags, premiere seating, etc.) totaled $2.1 billion, a 9.7 percent increase over 2009.

U.S. airlines have also continued to practice capacity discipline, i.e., maintaining very conservative growth plans, after reducing flights in 2008 and 2009. This lack of growth enabled system-wide passenger traffic to increase 3.4 percent over 2009 (domestic traffic was up 1.9 percent and international traffic was up 6.4 percent) while system capacity increased only 1.3 percent from 2009 (domestic capacity up 0.6 percent and international capacity up 2.6 percent).

While revenue rebounded significantly in 2010, costs did come under pressure from both increasing fuel prices and lack of growth. As Chart 3 shows, fuel costs continued to rise throughout 2010. For the year as a whole, jet fuel per gallon averaged $2.15, a 29 percent increase from 2009's average of $1.66 per gallon. This is clearly a significant increase considering that every 1 cent increase in jet fuel costs results in, approximately, an additional $170 million in expense for the industry (excluding hedging impact).

In addition to fuel, the industry had to deal with other rising costs. Many airline costs include yearly increases for items such as longevity and pay rate changes for labor and rate increases for performing maintenance on aging equipment. Additionally, when airlines do not grow, they are not able to spread their fixed costs over a larger base. Often times it's said that airlines struggle to "shrink to profitability," and this is one of the major reasons why—without leveraging the fixed costs by growing, and without hiring new employees at lower wages, they face cost pressures from existing arrangements.

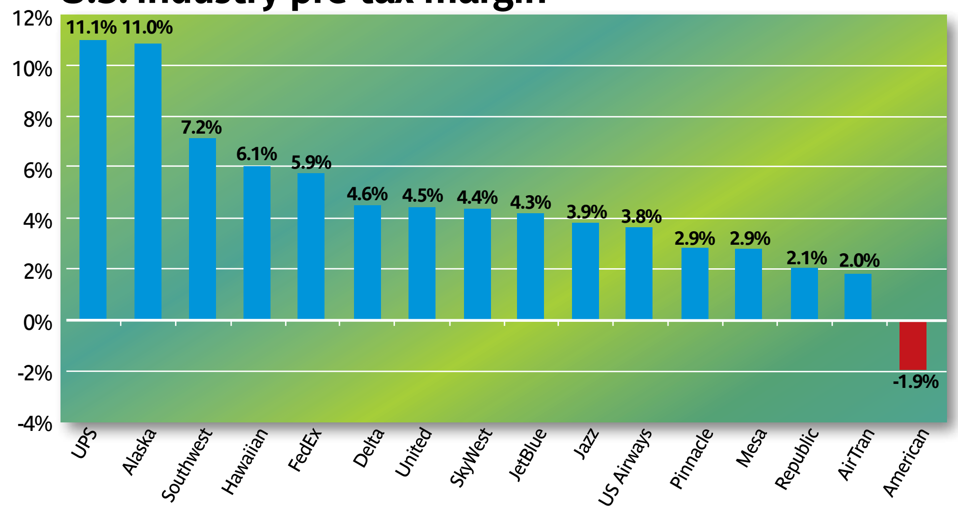
The good news for 2010 was that increases in revenue greatly outpaced the costs. As Chart 4 (see page 16) shows, nearly every U.S. airline was profitable in 2010.

Express market sees a shake-up

While the express airlines listed in Chart 4 did post profits, this sector of the industry continued to be affected by competitive pressure in 2010 as there was little growth and significant competition for existing flying. This highly competitive market

CHART 4: PROFITS FOR THE INDUSTRY IN 2010

U.S. industry pre-tax margin



Excludes one-time events, special items, and fuel hedges. Data for UAL includes results for CAL for whole year.
Source: E&FA analysis of company filings. Data are for corporate results.

spurred several airlines to take strategic actions looking for additional business opportunities. Republic, for example, purchased Frontier and Midwest, placing them in a segment of the industry outside of the express market. This sector also saw consolidation as Delta sold Mesaba to Pinnacle (which also chose to merge Colgan into Mesaba), and sold Compass to Trans States Holdings, which now operates three subsidiary airlines. SkyWest acquired ExpressJet and announced that it would merge the airline with its wholly owned subsidiary, Atlantic Southeast.

Even express airlines that remained wholly owned by their major partners were not immune from competition, as Comair is being forced to retire 49 50-seat CRJs by the end of 2012 (reducing its current fleet by more than half), and as AMR Corporation is looking for ways to divest American Eagle.

Fortunately for several express airlines, they continue to have longer-term agreements with their major partners that guarantee some levels of flying and a limit on short-term risks regarding revenue and fuel. It appears that there will continue to be competition even for existing flying, and additional mergers or other strategic actions are possible.

Air cargo expands after a challenging year

Similar to the passenger market, air cargo demand increased sharply in 2010 as a result of the economic recovery, with both UPS and FedEx Express posting strong earnings, as Chart 4 shows. As a result of the sharp increase in demand, 2010 global cargo traffic levels increased 20.6 percent from 2009, and capacity grew 8.9 percent. It's common in economic cycles to see cargo demand rebound sharply after a period of weakness as companies replenish their supplies and warehouses for anticipated demand. Companies are often willing to let inventory levels drop significantly until they believe demand has rebounded, and then many companies increase their cargo demand at once. That appears to be what happened, as traffic increased in early 2010 and then leveled off at closer to historic norms mid-year. Long-term cargo capacity growth trends should remain positive. Boeing predicts growth rates of about 5.9 percent per year from 2010 to 2029.

Outlook

As 2011 began, the outlook for revenue continued to be strong and was expected to outpace economic growth. Many airlines began to consider increasing their growth plans and focused on strengthening their balance sheets by generating sufficient free cash flow to pay down debt.

As the first quarter starts to wind down, the revenue outlook remains strong, but the recent increase in fuel costs raises concerns for 2011 performance (see Chart 5). As of March 7, jet fuel prices were already up 24 percent since the beginning of the year. Adding to the uncertainty of the fuel outlook is the sudden and renewed volatility in the price of refining crude oil into jet fuel (known as the crack spread). Throughout 2010, the crack spread floated between $7 and $15 per barrel; during periods in 2011, the crack spread has spiked to more than $30 per barrel. Unfortunately, this adds another significant variable to fuel prices and highlights that there is fuel risk for the industry beyond what happens in the crude oil markets.

In short, the 2011 outlook will largely be determined by the tug of war between fuel and revenue. So far, airlines have been able to offset a good amount of the rise in fuel with fare increases. Airlines have raised fares six times already in 2011 to combat higher fuel prices, compared to just three times in 2010. This fare increase is affecting the entire industry as

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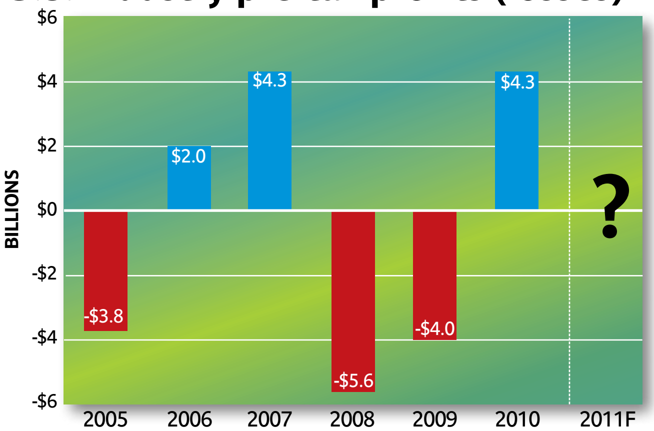
low-cost airlines, including Southwest, are directly affected by rising fuel prices and are also initiating fare increases. As long as passenger demand remains, the higher fares should remain, and potentially more increases are possible. Over the longer term, if fuel prices stay at such escalated levels, it is likely we will see growth plans reduced or even capacity pulled out of the market (as evidenced by several major U.S. and Canadian airlines announcing capacity plan reductions over the past several weeks). However, if there is a quick and sustained drop in fuel prices and the recent fare increases stay in place, the airline industry could enter a period of strong profitability, but this is only one of several scenarios at this point.

For now, many analysts have already reduced their earlier forecasts. While still projecting a profitable 2011, they are not expecting that profitability will equal or exceed that of last year. Analysts are likely to revise their forecasts depending on whether fuel prices continue to rise and airlines continue to increase fares.

ALPA's Economic and Financial Analysis Department will continue to monitor these and all other financial and economic indicators as their effect on the airline industry is critical to its members and to the Association.

CHART 5: RECENT FORECAST CALLS FOR 2011 PROFITABILITY BUT FUEL LOOMS

U.S. industry pre-tax profits (losses)



Airlines included the following: AAI, ALK, AMR, DAL, LCC, UAL/CAL
Source: E&FA analysis of company filings (2005–2010)

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