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U.S. Carrier Load Factor Growth and the Drive to Eliminate Uneconomic Capacity

33rd Annual FAA Aviation Forecast Conference

March 11, 2008

Washington, D.C.

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Thesis

- Record setting carrier load factors are greatly driven by carriers' desire to eliminate uneconomic (excess) capacity from their systems and improve Return On Invested Capital
- Question #1: How much excess capacity is in the system?
- Question #2: What realistic cost, revenue and load factor levers remain for carriers to continue to reduce excess capacity?
- Question #3: What are the risk factors for continued carrier profitability?

Agenda

- Definitions
- History Lessons and the Current Profit Cycle
- Excess Capacity in Current Cycle
- Profit Levers in Eliminating Excess Capacity
- Risk Factors to Continued Profitability

Why Is The FAA Interested In Load Factors?

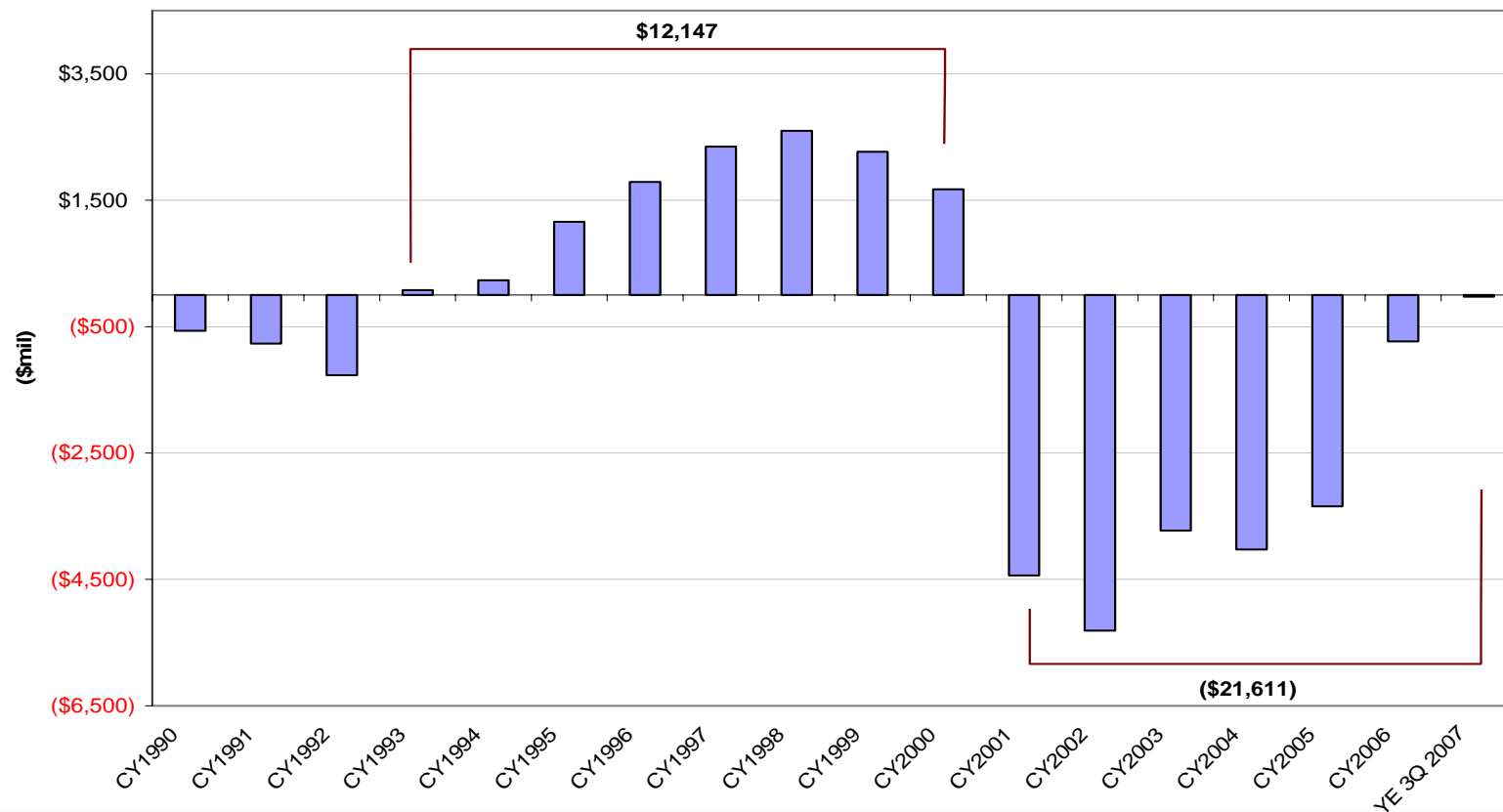
- The FAA has great interest in accurately forecasting carrier load factors, as it is one of the driving variables of projected FAA workload requirements
- FAA's forecast model considers load factors in conjunction with passenger volume, yields, length of haul and carrier ASM simultaneously
- Ceteris paribus, higher load factors require fewer airline flights, leading to lower FAA manpower and other ATC asset and operating cost requirements

Basic Definitions

- Uneconomic Capacity → deployed capacity (ASM) whose Rate of Return does not cover its cost of capital → excess capacity
 - It has nothing to do with seat availability on a particular flight
 - Different from accounting profitability → it considers opportunity costs
- WACC → Weighted Average Cost of Capital
 - Average cost of firm's financing costs for equity and debt
 - It is a risk-adjusted measure of investors' and lenders' required compensation for investing in, or lending to firm
 - Typically the hurdle rate for evaluating asset profitability
- Return On Invested Capital
 - Net Operating Profit = $(\text{EBIT} + \text{Net Interest}) * (1 - \text{Tax Rate})$
 - Capital = $(\text{Assets}) - (\text{Current Liabilities}) + (\text{STD}) + (\text{A/C Op Leases} * 7)$
- Focus of Analysis → Big Six Legacy Carrier Domestic Divisions
 - AA, AS, CO, DL, NW, UA
 - Form 41 filings

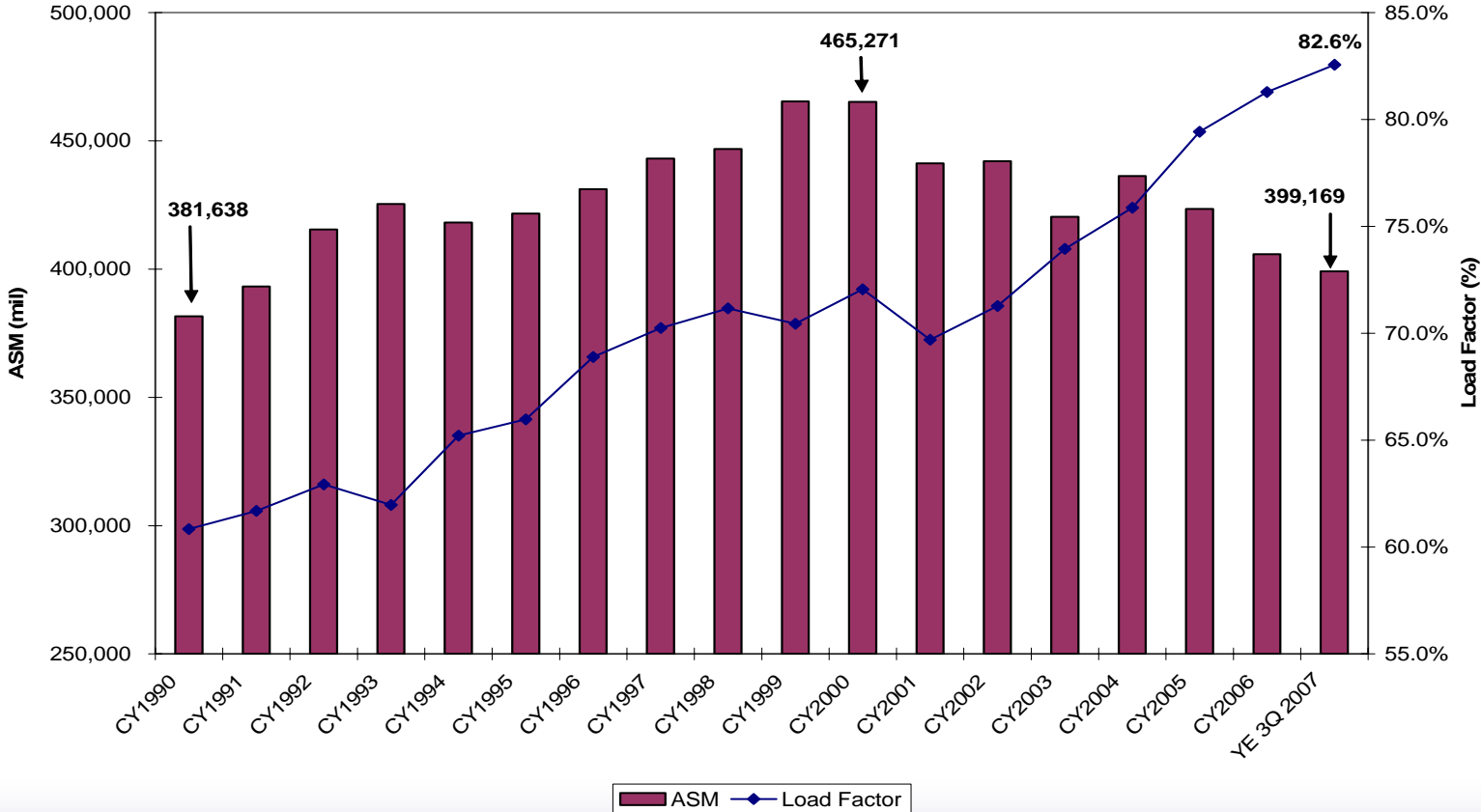
Legacy Carriers Attained Break-Even In 2007 Looking to Enter a New Profit Cycle

Legacy Carrier Domestic Net Operating Profit



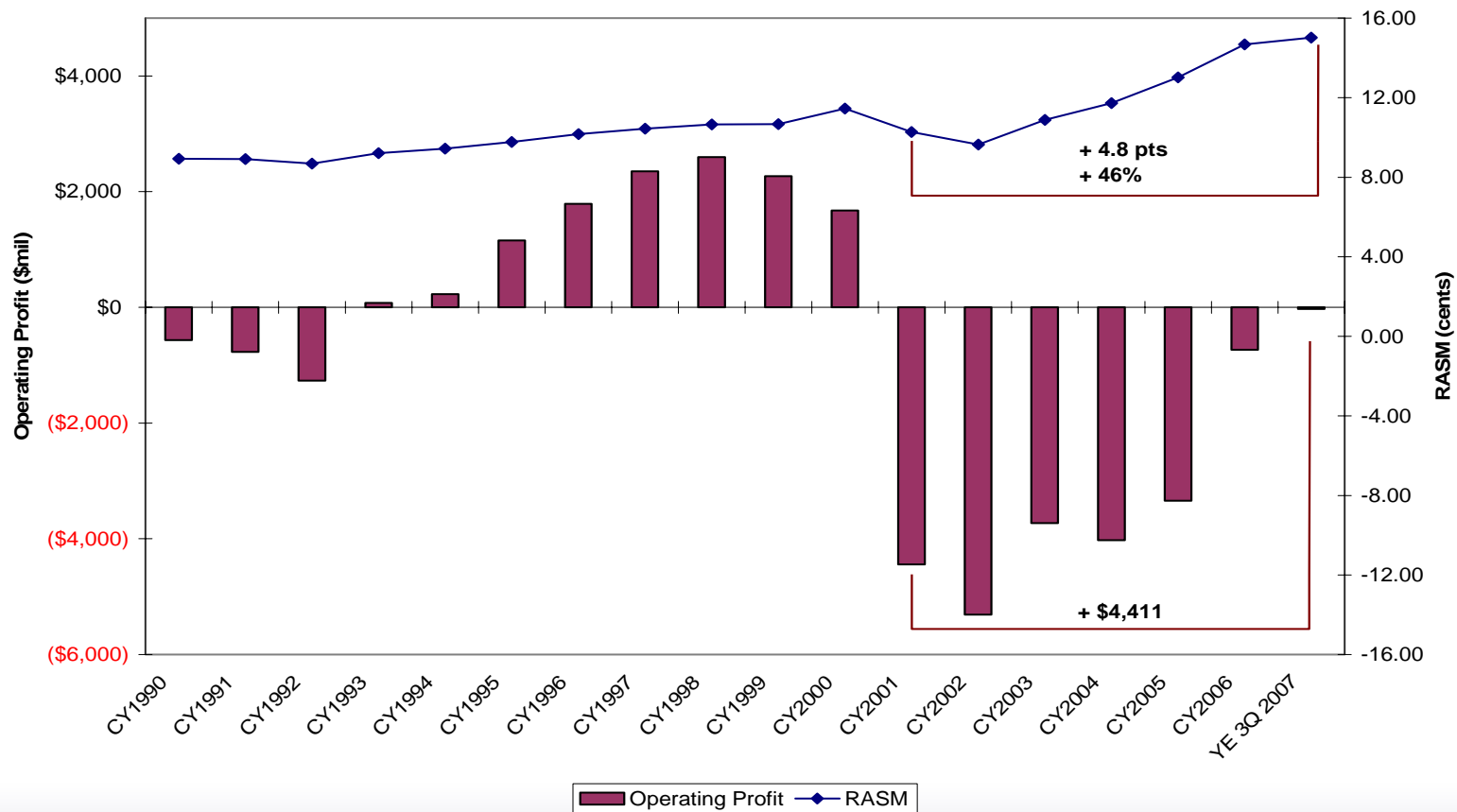
Passenger Load Factors Have Reached Historically High Levels On 14.2% Decrease in ASM Since CY2000

Legacy Carrier Domestic ASM and Load Factor Trend



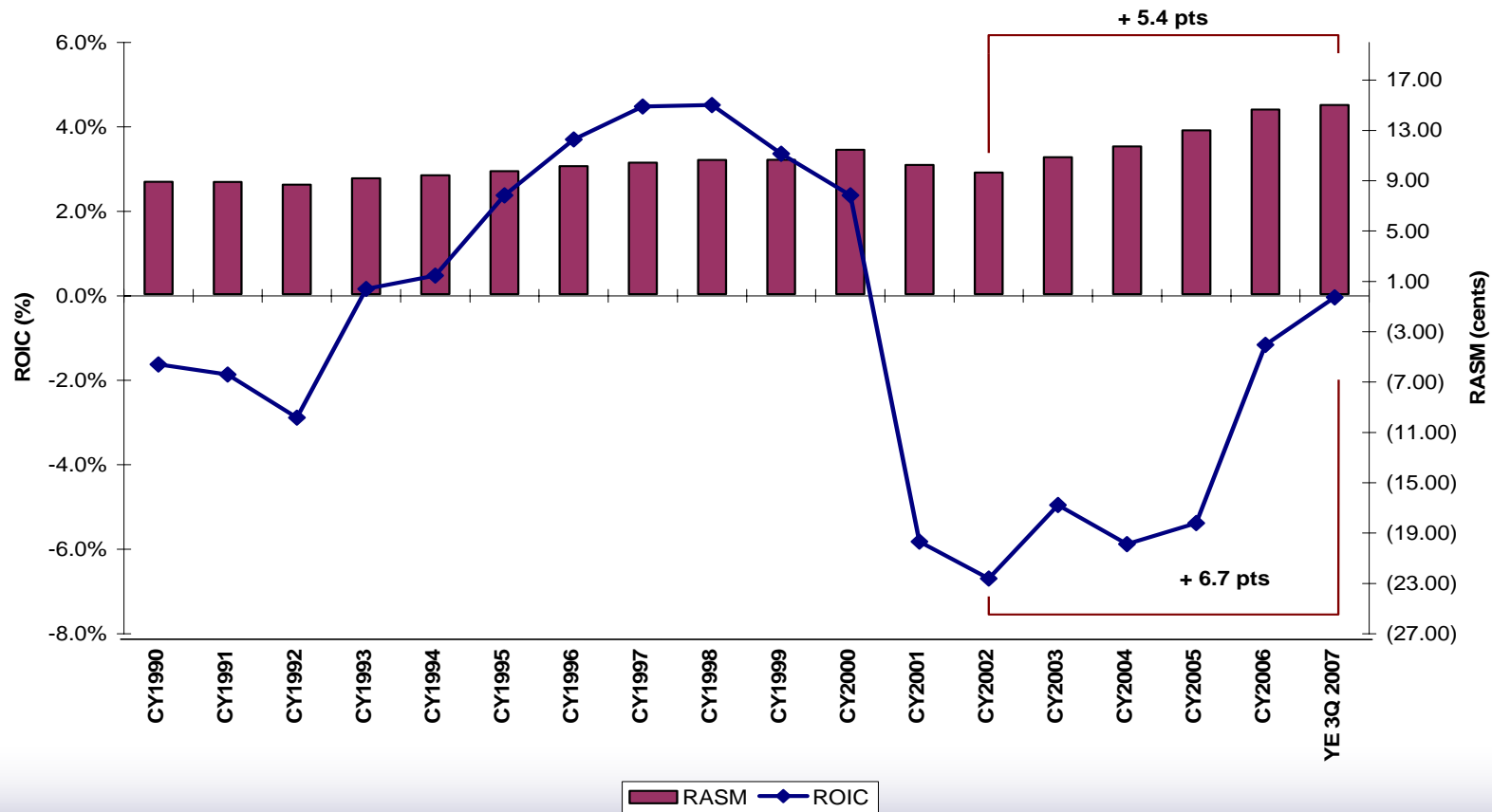
The Latest Industry Profit Turnaround Reflects Improvements in RASM

Legacy Carrier Domestic Net Operating Profit and RASM Trend



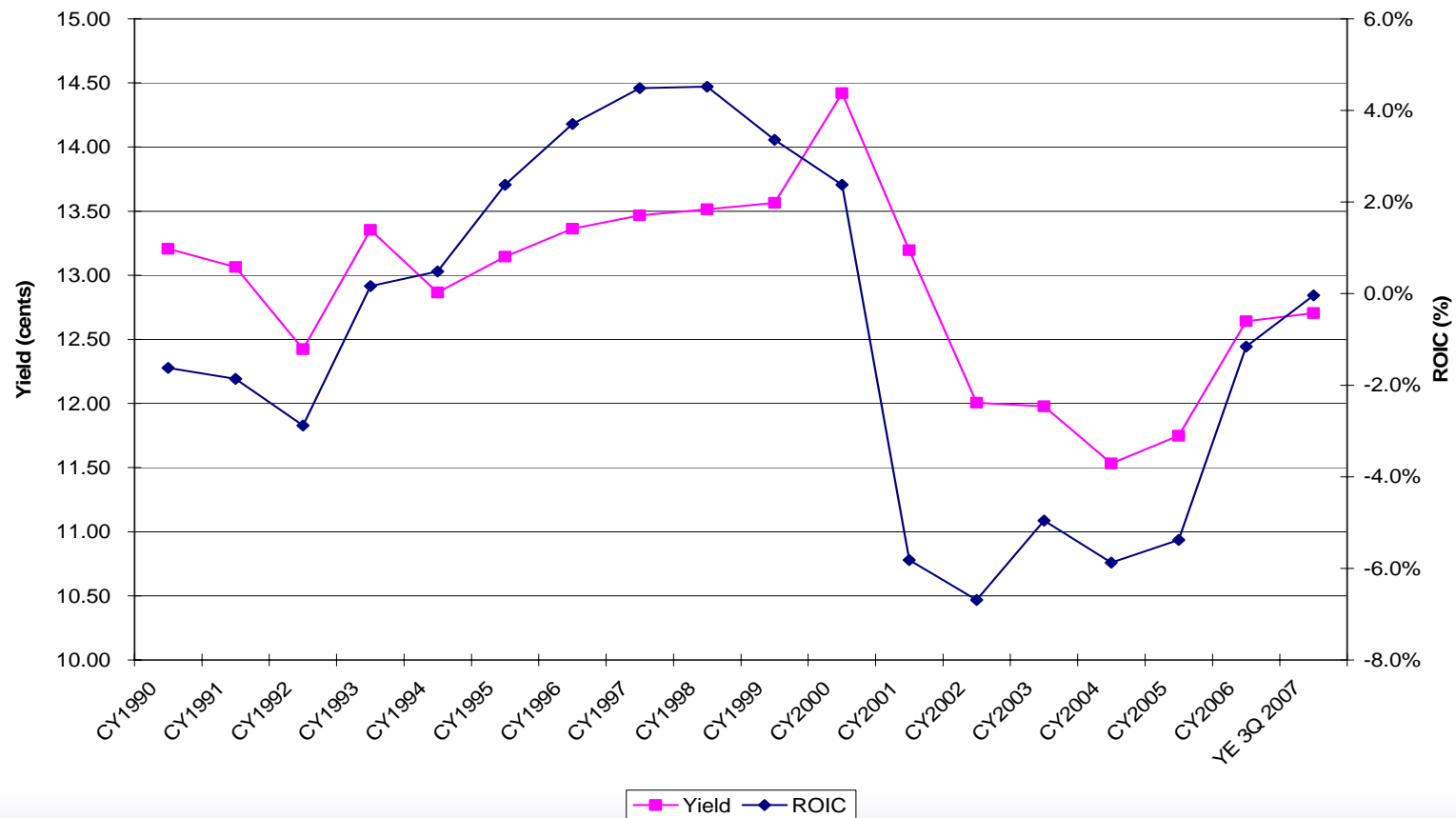
Since CY2000, as RASM Goes, So Does Return on Invested Capital

Legacy Carriers Domestic RASM vs. ROIC Trend

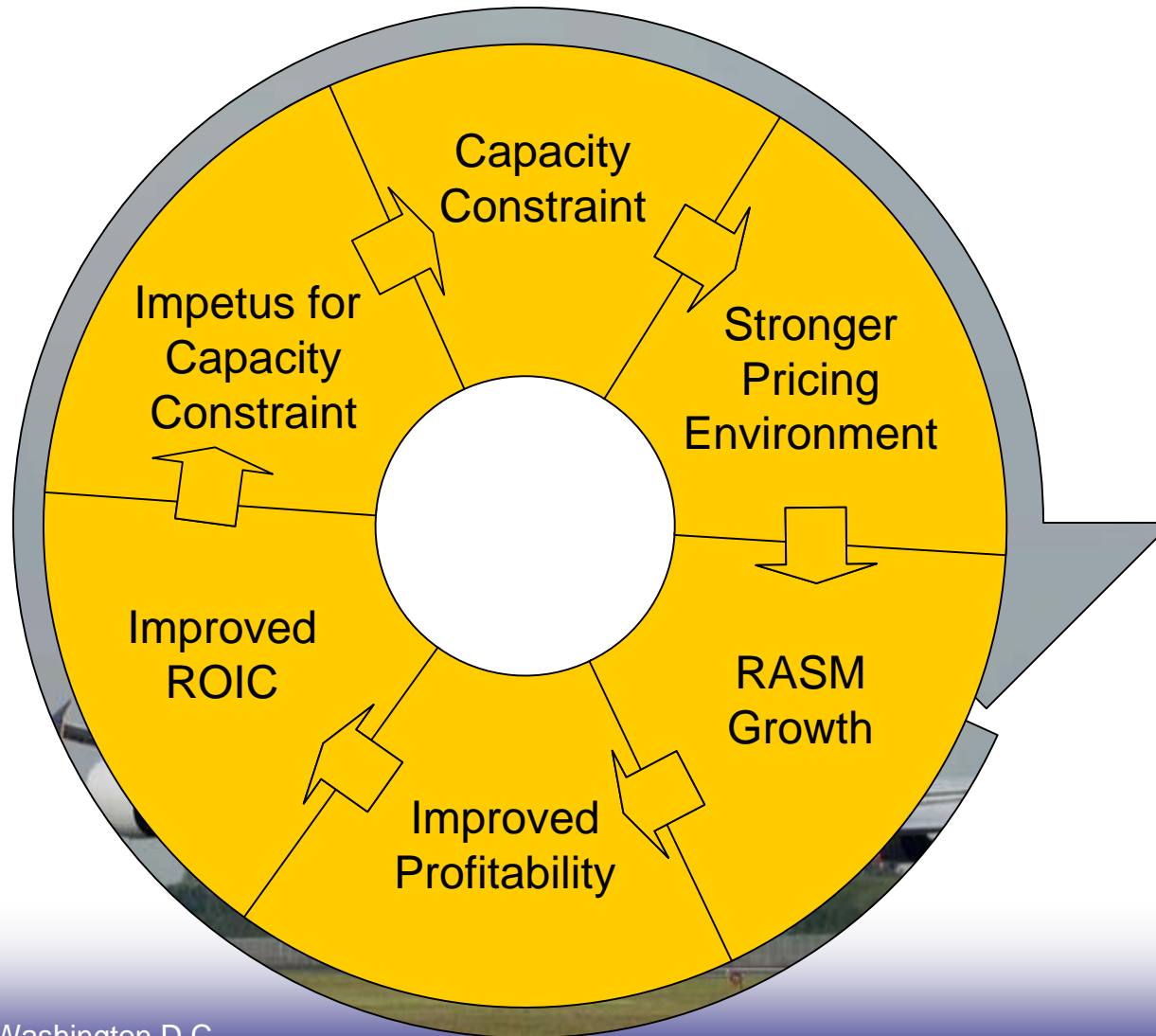


Historically Yield and ROIC Tend to Move in Tandem, Especially Since CY2000

Legacy Domestic Yield and ROIC Trend



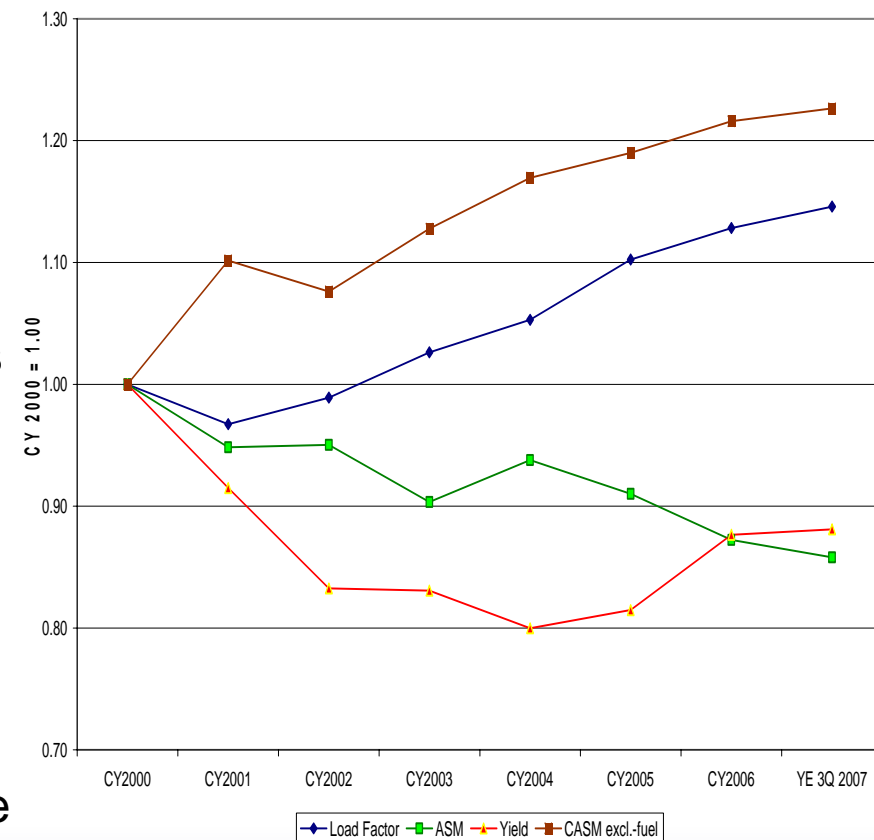
Carriers Attempt to Pursue a Virtuous Cycle of Capacity Constraint



Legacy Carriers Are Focusing on The Fundamental Drivers of Profitability: Load Factor, Yield, Unit Cost

- The key is to keep load factor growth greater than ASM growth while increasing yields
- Legacy Domestic ASM is down 14.2% since CY'00, much of it transferred to Regional/Feeders
- Load Factors are 10.5 points above CY'00 and have been keeping pace with CASM
- Although YE3Q'07 yields are (11.9%) below CY'00, they have increased 10.2% since CY'04

Legacy Carriers Domestic Trend Lines Since CY 2000



Legacy Carrier Performance Is the Best Since CY2000

- Legacy Domestic operations have shrunk significantly since CY'00, but Load Factor and RASM improved substantially, yet profitability still has not recovered
- Fuel price increases consumed \$8.0 billion in Net Operating Profit
- Increase in Capital Employed has outpaced profitability, reducing ROIC

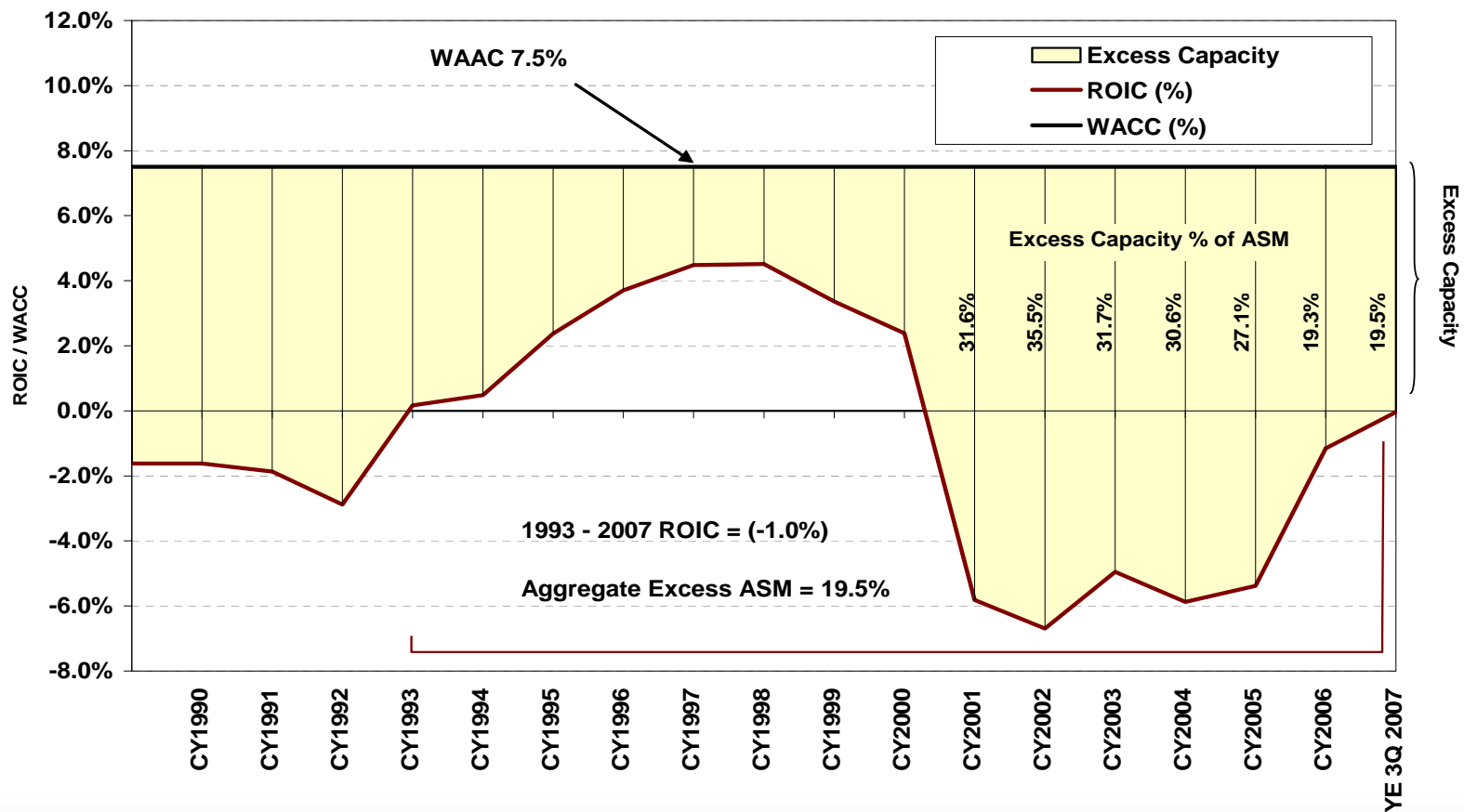
Domestic Legacy Carriers	CY2000	YE 3Q 2007	Variance	Percent
Passenger Revenue (mil)	\$48,342	\$41,868	(\$6,475)	-13.4%
Net Operating Profit (mil)	\$1,672	(\$28)	(\$1,701)	-101.7%
Net Op. Profit @ CY2000 Fuel Price (mil)	\$1,672	\$7,982	\$6,310	377.3%
RPM (mil)	335,242	329,542	(5,701)	-1.7%
ASM (mil)	465,271	399,169	(66,102)	-14.2%
Load Factor	72.1%	82.6%	10.50	
Average Fare per Passenger	\$140.92	\$140.02	(\$0.90)	-0.6%
Yield (cents)	14.42	12.70	(1.72)	-11.9%
RASM (cents)	11.46	15.02	3.56	31.1%
Capital Employed (mil)	\$70,293	\$73,708	\$3,415	4.9%
ROIC (%)	2.4%	-0.04%	(2.4)	
Profit Margin (%)	3.1%	-0.05%	(3.2)	
Unit Cost per ASM (cent)	10.68	14.58	3.91	36.6%
Unit Cost per ASM excl. fuel (cent)	9.31	11.42	2.11	22.6%

Calculating Uneconomic Capacity

- Uneconomic ASM capacity is the difference between deployed ASM and the level of ASM that would allow a carrier to increase profitability sufficiently to equate ROIC with WACC
- Uneconomic capacity is a moving target derived from interaction of various factors
 - operating profit
 - invested capital
 - WACC
 - current fares
 - price elasticity of demand
 - carrier target load factors
 - deployed asm
 - meaningful assessment must consider a full profit cycle

During Current Profit Cycle Legacy ROIC Fell 8.5 Points Short of WACC Resulting in 19.5% Excess Capacity

Legacy Carrier Domestic Excess ASM Capacity



Eliminating 2007 Uneconomic Capacity Would Lead to \$5.5 Billion Improvement in Legacy Profitability

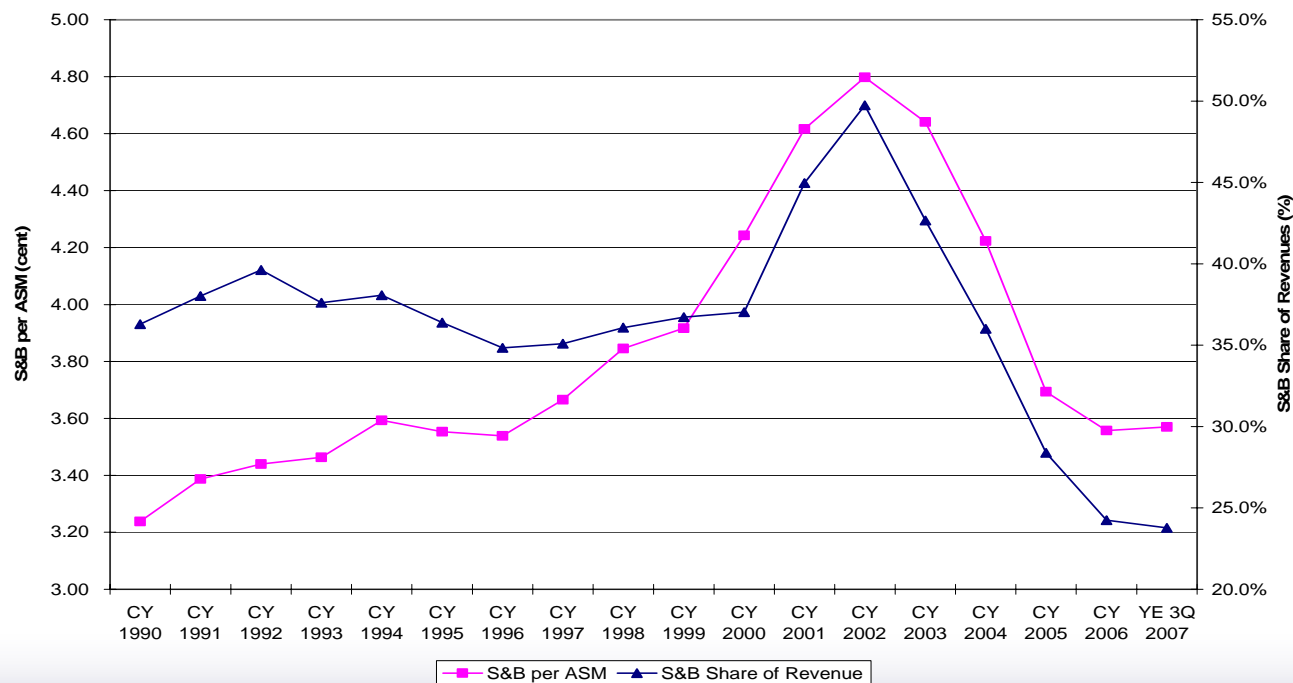
- Domestic Legacy fares would increase 21.8% (\$30 per passenger) at current load factors
- With price elasticity of demand at 1.10 passenger revenue would decrease (-2.0%)
- Operating costs would also decrease (-18.0%) → cost structure issues and further cost reduction requirements?

YE 3Q 2007 DOM Legacy	Current Results	Pro Forma Post-Reduction	Variance	Percent
Enplaned Passengers (000)	299,011	240,758	(58,253)	-19.5%
RPM (mil)	329,542	265,341	(64,201)	-19.5%
ASM (mil)	399,169	321,403	(77,766)	-19.5%
Load Factor	82.6%	82.6%	-	-
Passenger Revenue (mil)	\$41,868	\$41,045	(\$822)	-2.0%
Yield (cent)	12.70	15.47	2.76	21.8%
RASM (cent)	15.02	18.40	3.38	22.5%
Average Fare	\$140.02	\$170.48	\$30.46	21.8%
Operating Costs (mil)	\$58,206	\$47,725	(\$10,480)	-18.0%
Net Operating Profit (mil)	(\$28)	\$5,528	\$5,557	n/a
ROIC	-0.04%	7.5%	7.54	n/a

Cost Reductions Have Returned Great Dividends → How Much More Opportunities Left?

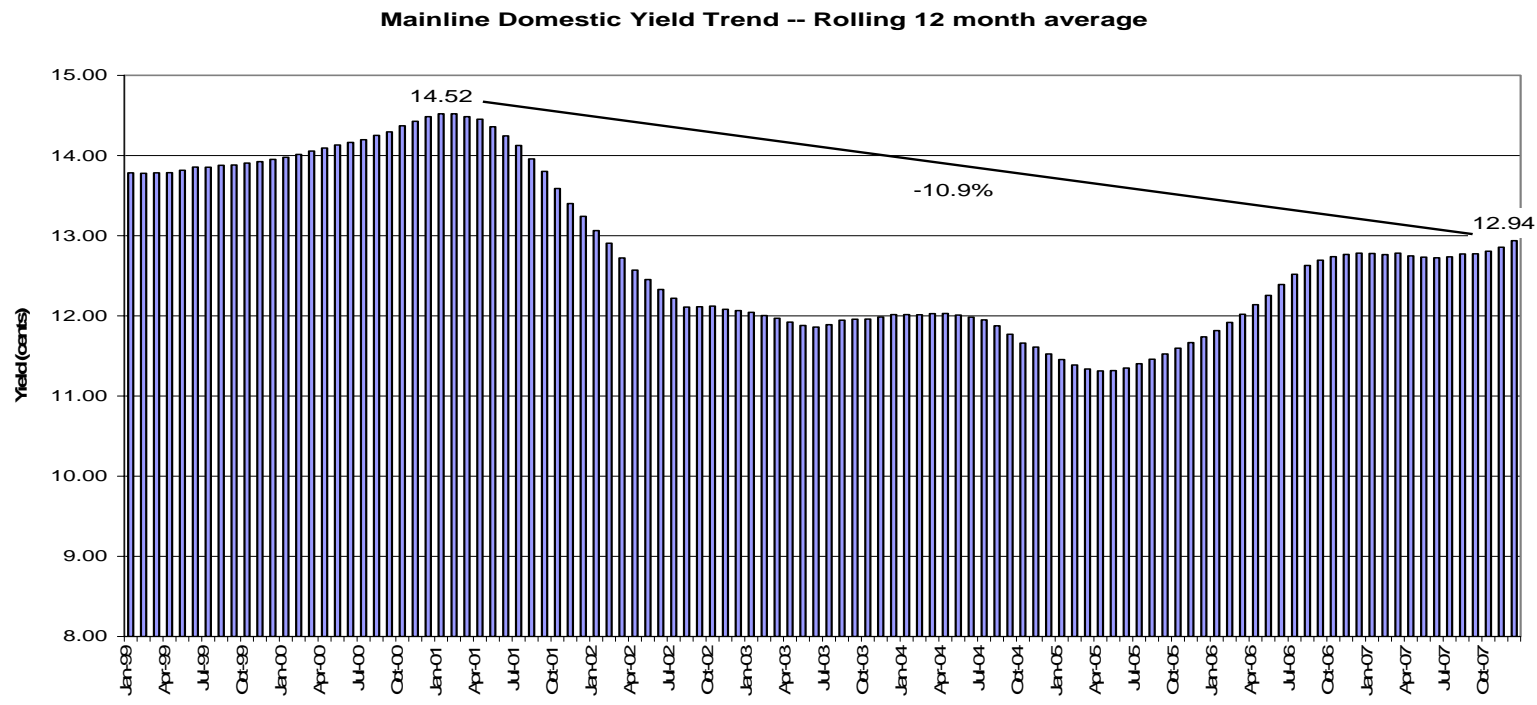
- No easy non-fuel cost reductions left to implement → low hanging fruit already harvested
- Labor cost reduction of 25.6% from CY'02 peak cost per ASM

Legacy Carriers Domestic Labor Cost Trend



How Much Higher Can Yields Go?

- Mainline yields are still 11% below January 2001 peak
- Yields have increased 14.4% since April 2005
- Continued increases depend on economic trends and carrier pricing power



How Much Higher Can Load Factors Go?

- So long as Legacy carriers continue to focus on profitability and ROIC metric, continued capacity constraint is expected
- Consequently, high load factors are here to stay, and carriers will attempt to increase them as much as possible → but, loads above current 82% will be difficult to maintain throughout the business cycle
- Potential economic softness and fuel price increases provide carriers continued incentive for capacity restraint
- Carrier capacity control extends beyond Legacy to Low Cost carriers
 - Continued downward revision of 2008 Domestic Industry capacity growth → Merrill Lynch 2008 Domestic capacity growth forecast reduced to 0.6% from 3.5% seven months ago (including Legacy, LCC and Regional / Feeders)
 - Announced carrier capacity trimmings include American, Continental, Southwest, AirTran, JetBlue

Has The Current Profit Cycle Run Its Course? → Risk Factors to Legacy Profit Improvement

- External forces → recession, fuel prices, terrorism
- Low hanging profit fruit (cost control) already achieved → competitive game now focusing on pricing with capacity control implications
- Legacy capacity constraint is running its course → how much more profitable reduction remains? → competitive responses to LCC growth?
- Is future Legacy profitability a function of continued pricing power? → have management learnt to replace market share metric with ROIC?
- Pricing discipline → weakest competitor is the weakest link
- Labor cooperation → Legacy unions are looking to recapture past contributions, especially as price of merger approval
- Is consolidation the next phase of Legacy carrier evolution? → Can carriers continue to shrink profitably? → Limited further upside to three profit levers