THE U.S. AIRLINE INDUSTRY:

INDICATORS SHOW IMPROVEMENT

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There is no question that the airline industry is unique, compared to other industries such as manufacturing and the services sector. Although the U.S. airline industry was deregulated in 1978, it still is heavily regulated in many areas and faces increasing government taxation on an almost yearly basis. What also makes the airline industry unique is the diverging view that airlines are public utilities expected to provide transportation at low fares as well as being for-profit companies expected to provide real returns to their shareholders. In addition, over this past decade the effects of outside factors, some of them beyond the industry's control, have been devastating. Increased terrorism, the downturn in the economy, the decreased level of passenger and cargo demand, higher fuel costs, and SARS and H1N1 have taken a toll on the industry and, particularly, on its employees. While 2009 was another challenging year, the dark clouds seem to be lifting, and the industry appears to be on the road to recovery.

Economy showing signs of improvement

To start to assess the current and future state of the industry, it's first necessary to analyze the demand engine that drives airline revenue: the economy.

The U.S. economy entered into a deep recession in late 2007, facing the worst economic downturn since the Great Depression. This downturn affected every level of the U.S. economy, as well as economies around the globe. Thankfully, the worst seems to be in the past, and we are now seeing signs of improvement. After four consecutive quarters of negative growth, the U.S. gross domestic product grew 2.2 percent in the third quarter of 2009 and is estimated to have grown 5.7 percent during the fourth quarter. Recent signs of stability and growth have been driven largely by government intervention aimed at bolstering the housing market, consumer spending, and financial markets. Current projections are for the U.S. economy to grow by approximately 3 percent in 2010.

Dampening the tentative signs of economic recovery, the U.S. unemployment rate remains high. The unemployment rate fell slightly from 10 percent in December 2009 to 9.7 percent in January 2010 but is expected to remain high throughout 2010. Many forecasters predict a slow "jobless" recovery in which the economy grows without a substantial increase in the employment rate.

Given that this industry is a globalized one, it's affected by global economic performance as well. Fortunately, signs of world economic growth and renewed stability in demand also point to recovery. After an estimated 6.5 percent decline during the first quarter of 2009, the global economy began to improve and is expected to decline by only 0.8 percent for all of 2009. The global economy's turnaround has been driven by robust growth in Asia and by stabilization or moderate recovery in other countries. However, the economic recession in Europe has affected certain countries more than others, resulting in a mixed outlook for this part of the world. The global economy in aggregate is expected to grow moderately (roughly 3 percent), according to the International Monetary Fund.

Recession eases grip on airlines

As a result of the economic downturn, the airline industry was severely affected as corporate budgets tightened, consumers spent less, and demand for air travel and freight weakened. The recession touched every sector of the industry, as evidenced by significant revenue and traffic declines.

System passenger traffic for the U.S. airline industry in 2009 fell nearly 6 percent on a year-over-year basis. Airlines implemented fare sales to buoy recession-weakened demand, but this was not enough to stimulate traffic, and airlines were forced to cut their capacity even further. "Premium" passengers, who generate approximately 20 percent of an airline's revenue, were affected by shrinking corporate budgets and either postponed travel or purchased economy tickets. As a result, estimated 2009 system passenger revenues fell even more than passenger traffic, down roughly 18 percent year-over-year—a steeper downturn than what the industry suffered in 2001. Lackluster passenger demand and lower passenger revenues led to a continued focus on "other" or ancillary revenues, including fees for checked luggage and preferential seating. The global economic recession also affected trade and shipping demand, causing system cargo traffic to fall nearly 11 percent in 2009 over 2008 levels.

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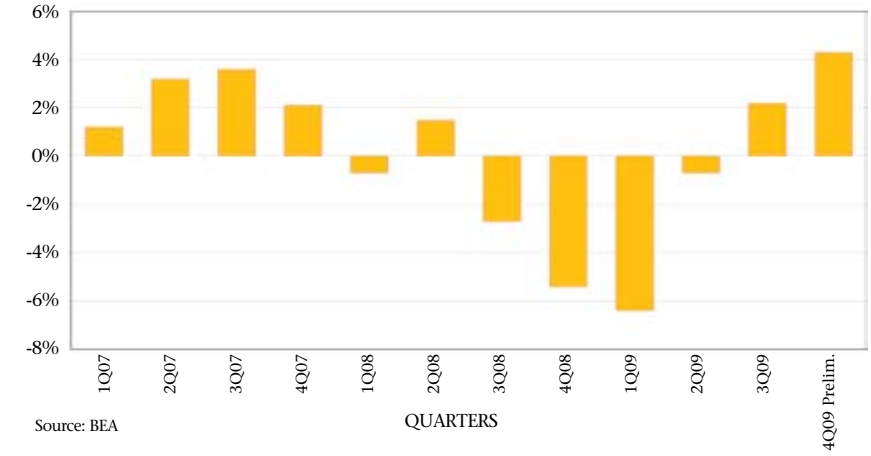
The "Passenger Revenues and Cargo Traffic" chart depicts the significant declines in year-over-year passenger revenues and cargo demand through summer 2009. However, the chart also indicates the positive effect that strengthening domestic and global

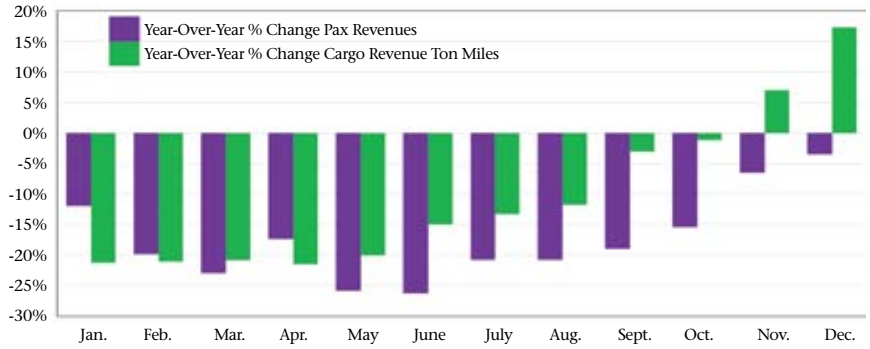
THE BEGINNING OF ECONOMIC RECOVERY

Real Gross Domestic Product Percent Change

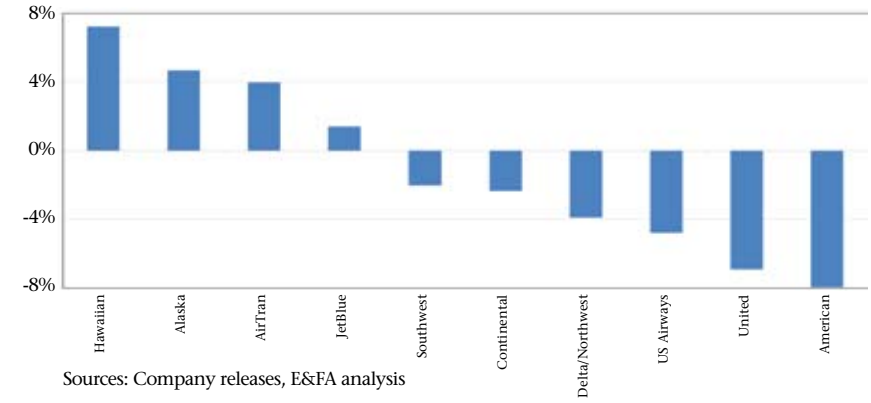


Source: BEA

PASSENGER REVENUES AND CARGO TRAFFIC BEGIN TO SHOW SIGNS OF IMPROVEMENT IN 2009



2009 PRE-TAX MARGINS, EXCLUDING SPECIAL ITEMS



Sources: Company releases, E&FA analysis

economies, as well as continued capacity constraint, had on demand in the second half of the year. System passenger revenues, while still negative year-over-year, have steadily improved. In June, system passenger revenue was down roughly 26 percent over June 2008 levels. By December, system passenger revenue was down roughly 4 percent over December 2008. System passenger traffic has seen consecutive improvements since May's 10 percent year-over-year decline to a roughly 1 percent decline in December. System cargo traffic has improved significantly since hitting a floor of approximately a 22 percent decline in April to more than 17 percent in growth for December 2009. This large boost in traffic was brought on by increased demand for air cargo over other modes of transport, as shippers require faster transport of goods due to economic revival. Year-over-year comparisons in passenger revenue are expected to follow cargo's trend and turn positive within the coming months.

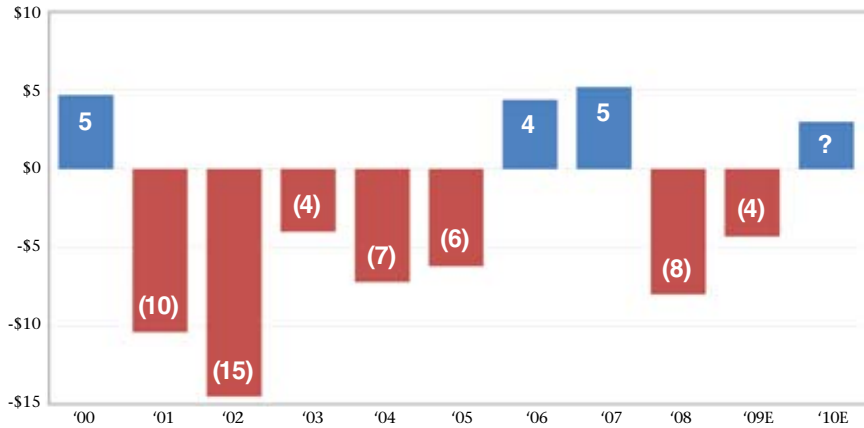
While recent improvements in demand and revenues have been encouraging, they were unfortunately not enough to overcome the significant declines earlier in the year. As a result, most airlines reported pre-tax losses for all of 2009. The "2009 Pre-Tax Margins" graph depicts pre-tax margins for U.S. airlines, excluding special items. Several of the airlines that posted the largest negative margins are the airlines that were exposed to the most recession-affected revenue types—international and premium travelers. Early indicators suggest that the business passenger is returning. Booking data are looking more positive and providing a clearer picture of revenue trends as more passengers are booking further in advance than last year.

Not surprisingly, the other large factor affecting profitability in 2009 was the cost of fuel. Though still volatile throughout 2009, crude oil prices averaged about $62 per barrel, well below 2008's average of nearly $100 per barrel. However, the effect of 2008's record fuel prices lingered into 2009 in the form of "harmful" fuel hedges. These hedges were put in place at the height of fuel prices in 2008 and became a drag on earnings after fuel prices fell. During 2009, realized hedges (operating and non-operating) were a large component of airline pre-tax losses and added roughly $3 billion in losses for mainline airlines, compared to approximately $1.2 billion in gains in 2008. As this article is written, crude oil prices are approximately $80 per barrel, and its volatility continues to be of great concern to the industry.

As this issue goes to press, many of the express airlines have not yet released their 2009 full-year results. Typically, due to the structure of their contracts

LIQUIDITY AS A PERCENTAGE OF 2009 REVENUE

INDUSTRY PRE-TAX PROFITS (LOSSES) IN $BILLIONS



with their major partners, most express airlines experience less volatility in their earnings. This, however, does not mean they have been immune to industry problems. In prior economic downturns, express airlines benefitted from the transfer of capacity from mainline to regional jets. During this downturn, however, many express airlines saw their flying reduced and faced increased competition from their legacy partners as well as from other express partners flying under the same brand. As a result of mainline industry challenges, legacy partners scrutinized their express airline contracts in 2009. Some agreements that allowed express airlines to post better margins than their legacy partners morphed into deals that added risk (including fuel) to the express sector.

Airline financial stability was also affected by a tightening credit market, and some airlines faced the possibility of violating financial covenants or even declaring bankruptcy due to liquidity concerns. However, as 2009 progressed the capital markets started to improve, and airlines were able to raise capital, renegotiate some debt agreements, and increase liquidity during the second half of the year. Since August 2009 AirTran, American, Continental, Delta, Southwest, United, and US Airways have raised roughly $12.3 billion in liquidity, and many of these airlines were able to "take the liquidity issue off the table." As the "Liquidity" chart shows, almost all of the airlines had year-end liquidity balances of at least 15 percent of 2009 revenues (the ideal target is between 15–20 percent of revenues), and a few of the airlines have raised even more cash since yearend.

Outlook

In all, 2009 was a challenging year as the recession, weak demand, and fare sales caused more than $4 billion in pre-tax losses. However, economic growth, revenue improvements, and stronger demand are forecast to lead to pre-tax gains of nearly $3 billion for U.S. airlines in 2010.

In 2010, mainline passenger revenue trends are forecast to grow between 8 and 12 percent over 2009 levels, with international trends outpacing domestic. Business travel demand, which dropped dramatically during the recession, is expected to slowly strengthen with the improving economy and world trade. Cargo demand is also set to improve, as global inventories fall and purchasing managers look to increase orders.

While the airline industry is expected to almost certainly perform better in 2010 than 2009, there are risks to the strength and pace of that recovery, including capacity and fuel prices. Capacity is expected to increase slightly (flat to a 1 percent growth) in 2010, as the demand for air travel rises. However, airlines aiming to increase their market share could impede the recovery if they increase capacity too quickly. Fuel prices could also affect profitability if the recent rise continues and outpaces economic growth or increases in passenger and air cargo demand. In 2009, low fuel prices helped to offset weak demand, but in 2010 the opposite is expected to happen, and higher fuel prices could affect demand and revenue recovery.

Despite the possible risks to the industry's recovery, if the budding growth in the industry and the U.S. economy continues, most U.S. airlines should have a profitable 2010. More importantly, economic recovery is expected to continue and strengthen even further into 2011, resulting in a favorable environment to achieve ALPA's contract negotiation goals and enable the industry to weather additional challenges that come its way in this new decade.