STATE OF THE AIRLINE INDUSTRY

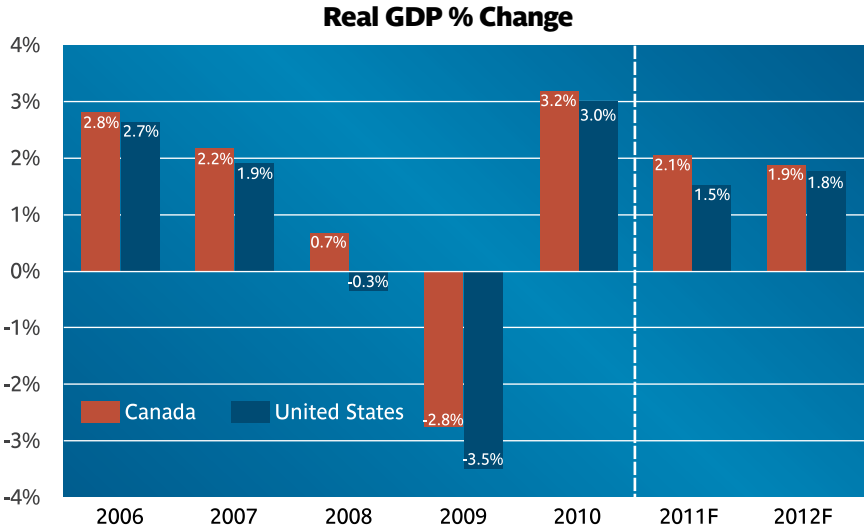
Airlines Manage Through An Uncertain Economic Period

By ALPA's Economic & Financial Analysis Department Staff

At this point last year, analysts projected that the airline industry would continue to recover through 2011. North American economic growth, while modest, was expected to continue, and the industry would capitalize on that growth to build on 2010 profits. A year later, however, a review of three quarters of financial data shows that the economy has not rebounded as anticipated, yet the airline industry still managed to remain in relatively good shape. What was supposed to be a recovery year has ultimately been a "manage through" year, but the industry has shown more financial resiliency than during previous periods of economic challenges.

Adding to these challenges, fuel prices began to spike again early in 2011, prompting airlines to reduce capacity. As worldwide events contributed to a strain on the economy, reducing capacity proved worthwhile, as the industry was still able to manage double-digit increases in passenger unit revenue for most of the year. This strong revenue performance is the primary reason the airline industry is expected to produce a profit of approximately $1.5 – 2 billion for the year. While that amount is clearly down from the nearly $5 billion earned in 2010, it's still noteworthy, given the state of the economy.

Chart 1: Limited GDP Growth Expected

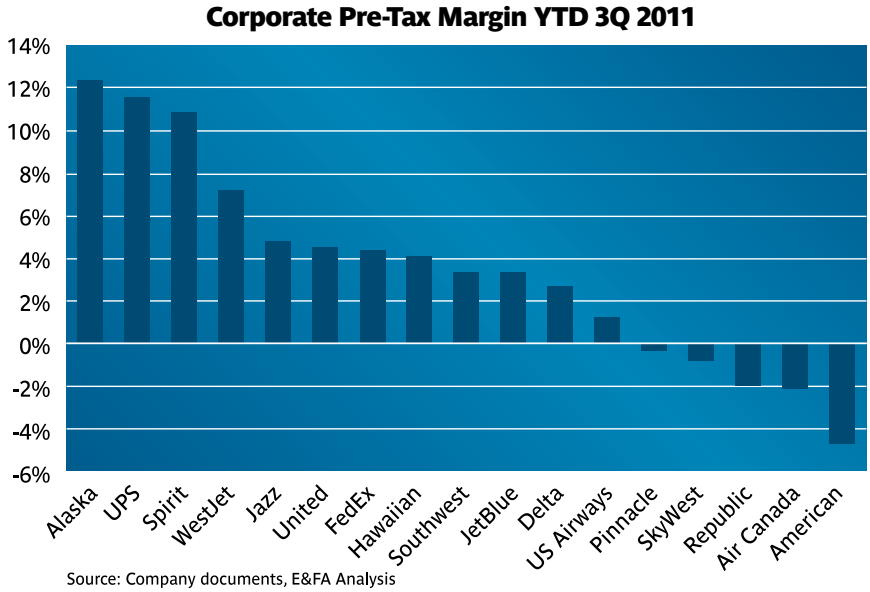


Source: BEA, E&FA Analysis

A series of unfortunate economic events

It's been nearly impossible to overlook the struggles of the North American and worldwide economies in 2011. Coming out of the recession of 2009, the global economy improved significantly in 2010, and most economists expected that improvement to continue into 2011. Unfortunately, the expected growth rates were cut short by a series of unfortunate economic events, including but not limited to the Japanese earthquake and tsunami, which caused significant supply chain shortages; a run-up in the price of oil due to the political uprisings in the Middle East, as well as increases

Chart 2: Respectable Profit Margins for Most Airlines



Source: Company documents, E&FA Analysis

in the cost of refining crude into jet fuel (the crack spread); the U.S. debt ceiling debacle and near breakdown of the political process; and the continuing debt crisis in Europe. The latest gross domestic product (GDP) projections for the next three quarters show limited growth and are down nearly 1 percent from projections in June of this year. As Chart 1 shows, annual GDP growth for both the U.S. and Canada is expected to barely reach 2 percent in 2012.

In addition to the poor GDP growth rates, many other economic indicators reflect a weak economy. Job markets are stagnant, financial market volatility has increased, and consumer confidence is crumbling. Paring down of debt by households and banks, increasing government fiscal austerity, and declining business and consumer confidence are expected to restrain growth across many economies. With such a bleak backdrop, consumers have come to expect a prolonged period of economic stagnation. October consumer sentiment increased slightly from September but remains at historic lows, and the U.S. unemployment rate is still at a historically high level of 9.0 percent as job growth remains weak.

The Canadian economy is faring only slightly better than the U.S. economy. After an increase in September, employment declined by 54,000 jobs in October. October's loss pushed the unemployment rate up 0.2 percentage points to 7.3 percent. During the last year, total employment had risen by 237,000 (+1.4 percent). Although Canadian growth rebounded in the third quarter, underlying economic momentum has slowed and is expected to remain modest through the middle of 2012. The weaker economic outlook indicates a greater and more persistent economic slack than previously anticipated, with the Canadian economy now expected to return to full strength by the end of 2013.

Industry is managing in a difficult economic environment

Despite the economic uncertainty, the airline industry has been able to perform better than analysts had expected. Chart 2 shows that after nine months, almost all airlines, including mainline, express, Canadian, and cargo, are profitable.

The industry has experienced significant financial turmoil during the past decade, but it now seems to be positioned to weather impending storms or at least to react more quickly to soften their blow. Airlines are practicing better fundamentals by adjusting capacity, using innovative ideas for generating revenue, building up cash and paying down debt on balance sheets, and more efficiently managing costs such as distri-

Chart 3: PRASM Is Positive Despite Economic Uncertainty, But Has Slowed from 2010s Highs

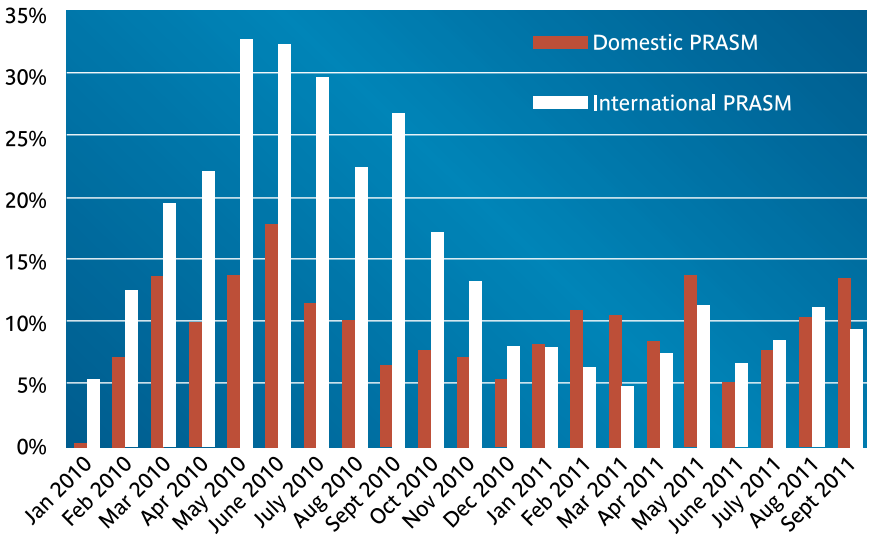


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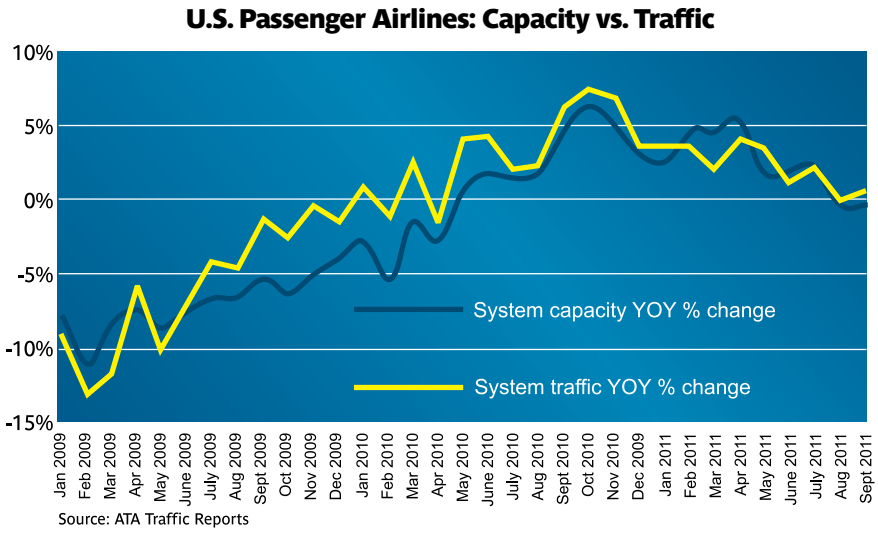
Chart 4: Uncertain Economy Pushes Airlines into Practicing Capacity Discipline—Again



bution and commission expenses.

The real positive outcome for 2011 has been the strength of revenue performance in the face of economic weakness. Chart 3 (page 17) shows the domestic and international passenger revenue per available seat mile (PRASM) year-over-year percent change. Every month of 2011 had better revenue performance than 2010 in both the domestic and international markets. In addition, several months had strong double-digit growth rates. Historically, when the economy isn't performing well, PRASM growth, let alone double-digit growth, is unusual. As the airline industry moves into 2012 with continued economic uncertainty, analysts will keep a close eye on this indicator to see if revenue starts to weaken.

One of the main contributors to the strong revenue performance in 2011 is the capacity constraint that airlines have been exhibiting. After cutting capacity during much of 2009 and 2010, airlines began to add capacity in early 2011. Yet early in the year, economic challenges spurred another round of capacity reductions. As Chart 4 shows, system capacity grew in the first half of 2011, but by August airlines had cut flying, which limited the available supply of seats and resulted in better pricing power (ability to increase fares). These cuts were expected to accelerate in the fourth quarter of this year. Current first quarter 2012 schedules point to international capacity growth of 1.4 percent and domestic capacity reduction of 0.4 percent, resulting in flat system capacity.

Fortunately, the capacity actions thus far have helped, and demand has not dropped as a result of a sluggish economy. Airlines have increased fares more than 11 times during 2011; and between January and September, system passenger traffic grew 2.4 percent. Even with several fare increases, industry traffic was still able to grow. While most of the revenue data have been positive, premium traffic declined in August from earlier in the year. Because business travel accounts for approximately two-thirds of airline revenues and premium traffic typically represents business travel, this decline is cause for concern. However, recent public comments from airline managements are pointing to business travel holding firm. Decisions on whether to cut or increase 2012 corporate travel budgets will be key to industry revenue performance.

Chart 5: From January 1 to November 8, Crude Oil Prices Grew 5.7 Percent While Jet Fuel Prices Rose 23.4 Percent

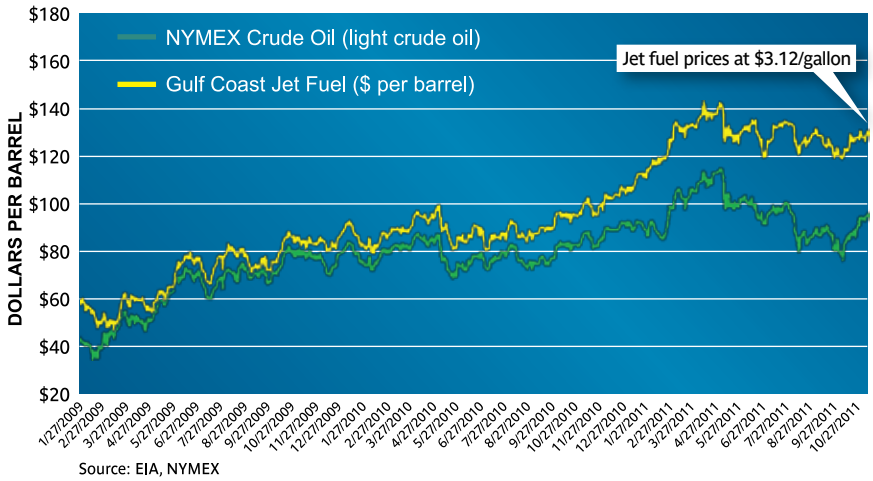
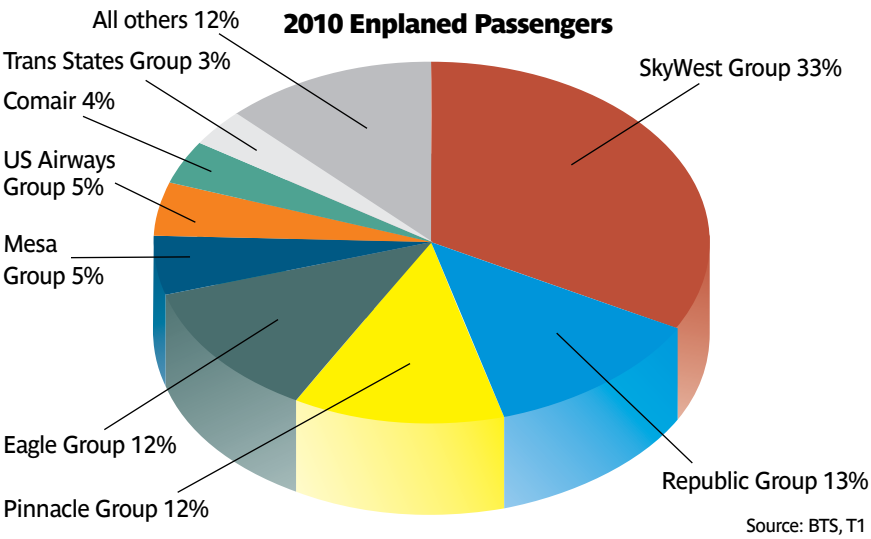


Chart 6: Top 4 Express Holding Groups Account For 70 Percent of Express Passengers



Source: BTS, T1

> While revenue is one of the positives in 2011, fuel remains a real challenge and a risk for all segments of the industry. Fuel prices have risen more than 20 percent from the start of the year and have recently spiked again after briefly decreasing over the summer.

In addition to capacity pullbacks contributing to better revenue results, another key component of this year's revenue performance is ancillary revenues—bag fees, change fees, and miscellaneous operating revenue. This revenue has become vitally important for airlines and their profitability and accounts for approximately 6 percent of passenger revenues. Ancillary revenues totaled $8.7 billion in 2010 and were up 11 percent after the second quarter of 2011, according to the Bureau of Transportation Statistics.

While revenue is one of the positives in 2011, fuel remains a real challenge and a risk for all segments of the industry. Fuel prices have risen more than 20 percent from the start of the year and have recently spiked again after briefly decreasing over the summer. This price increase is more the result of the rising crack spread (the difference in the price between crude oil and refined jet fuel) than the price of oil.

Chart 5 shows the growing crack spreads that the airline industry is facing. Crack spreads have risen more than 100 percent since January, and as of early November the price for jet fuel was back above $3 per gallon. The industry has done a reasonable job of raising fares to partially offset the increase in fuel costs; yet with a weak economy, airlines may not be able to raise fares again to offset fuel costs.

The recent run-up in fuel prices is due, in part, to instability in the Middle East and North Africa. Unfortunately, increases that are based on geopolitical events or speculation are particularly problematic, as they typically are not accompanied by the increased economic growth (revenue) that usually goes along with demand-based increases. Because predicting fuel prices is highly unreliable, the airline industry will need to rely on a mix of hedges and capacity actions to help manage fuel risk.

Express airlines continue to feel competitive pressure

Similar to the last few years, express airlines continue to struggle with limited growth, significant competition for flying opportunities, and increasing pressure from mainline partners. Unfortunately, with increases in fuel prices, the relative economics of some express aircraft have dropped substantially and have added to the challenges for both public and wholly owned express airlines.

In response to these pressures (note their low levels of profitability in Chart 2), many express airlines are seeking ways to restructure their business and adjust their business models. Pinnacle and SkyWest management indicated during third-quarter earnings conference calls that they are in the process of restructuring. Republic recently announced that it's looking to make its company leaner during 2012 and will seek buyers for its Frontier subsidiary. American has decided to divest its American Eagle subsidiary. While looking for ways to restructure or improve business is not new to the airline industry, it's relatively new for the express side of the industry and is a direct result of the intensely competitive marketplace.

Due to competition, this segment of the industry has also undergone consolidation. As Chart 6 shows, the express industry is now 70 percent controlled by just four holding groups. It may take several years for the industry to completely sort itself out, but an industry with fewer large airlines could lead to a more stable and profitable industry in the longer term. Fewer airlines bidding on flying would obviously lead to less competition

and would allow those carriers to build stronger relationships with their mainline partners and better leverage their fixed infrastructure and overhead.

Air cargo growth slows

While passenger airlines have been less affected by the weak economy, cargo carriers have been affected more. Chart 7 shows there was strong recovery in cargo traffic in 2010, and that greatly outpaced additional capacity. However, the trend reversed in 2011, and cargo carriers have experienced several months of negative traffic growth since May.

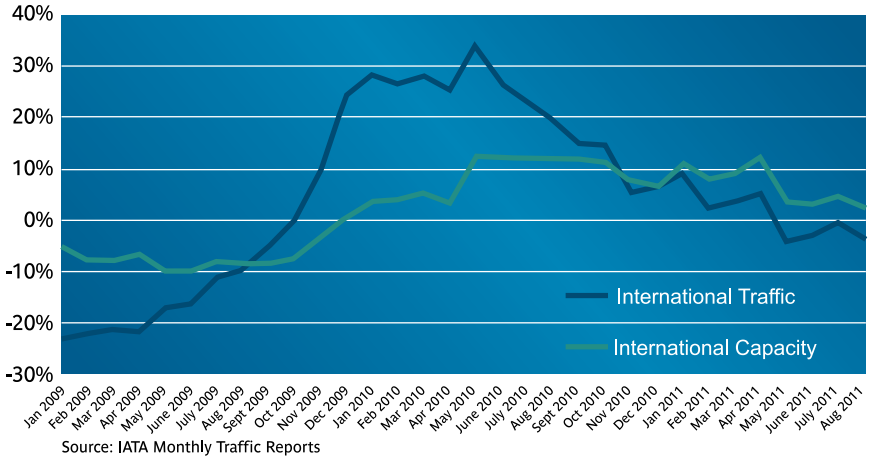
While these traffic numbers have been disappointing this year, it's important to keep in mind that cargo carriers like FedEx Express and UPS are much stronger financially than most of their passenger counterparts and are still posting respectable profit margins as seen in Chart 2. Yet, as with passenger airlines, higher fuel prices and a weak economy are affecting profit margins and growth plans in the cargo industry. Capacity plans for all cargo carriers are expected to be lower going into 2012 than longer-term growth estimates, and there will likely be less belly capacity on passenger airplanes. Taking into account that many emerging economies are still growing at high rates and have not seen the same declines in business and consumer confidence as Western economies have, global cargo revenues are still expected to increase 4.5 percent in 2011.

Looking to 2012

The financial performance of all segments of the airline industry is closely linked to the health of world economies, and the current global economic uncertainty remains an industry concern for 2012. For the moment, many North American airlines are performing relatively well, despite the economic headwinds, but can the industry keep it up? As reflected in Chart 8, most analysts expect the answer to be yes. Yet now more than ever, analysts don't have a clear view beyond the next few months and base most forecasts on existing conditions.

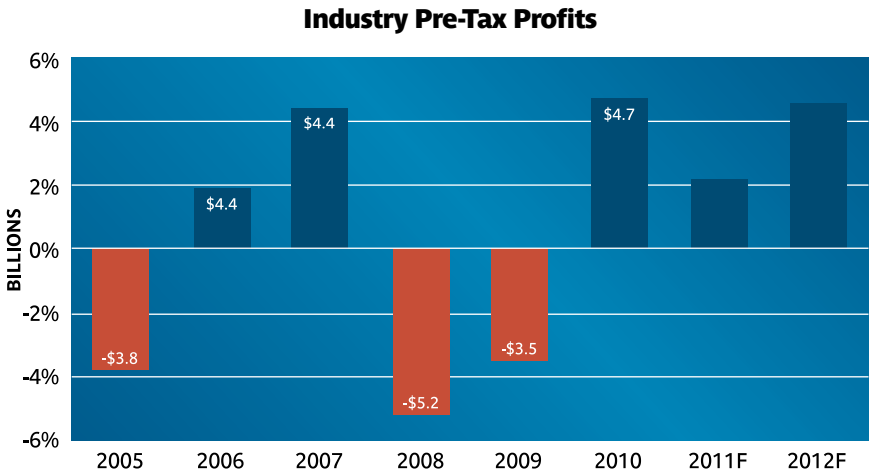
The reality is that the global economy and the airline industry can be quickly affected by any number of factors. So now more than ever, pilots and other airline industry stakeholders need to stay abreast of industry and economic conditions. ALPA's Economic & Financial Analysis Department will continue to monitor these and all other financial and economic indicators, as their effect on the airline industry is critical to members and the Association.

Chart 7: Cargo Capacity to Continue to Grow in 2011 But at a Higher Rate Than Demand



Source: IATA Monthly Traffic Reports

Chart 8: Despite Economic Fears, Industry Still Expected to Be Profitable in 2011 and 2012



Source: E&FA analysis of company filings (2005 – 2010), various analyst forecasts