STATE OF THE AIRLINE INDUSTRY

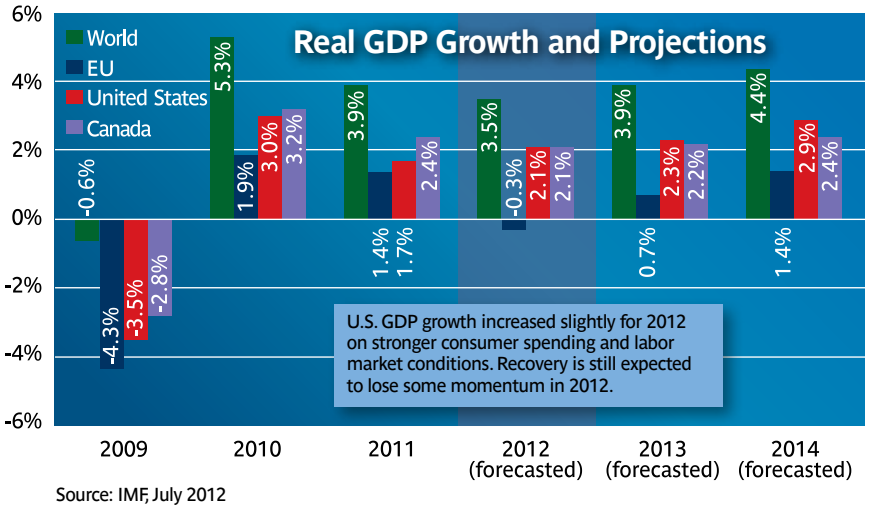
At the Halfway Point, Airlines Keeping Pace in 2012

By ALPA's Economic and Financial Analysis Department Staff

The airline industry faced a tough beginning in 2012, with external economic events continuing to place hurdles in the airlines' path toward sustained profitability. Fuel prices were rising once again, and the economy was at a near standstill, with all eyes focused on the European debt crisis. Still, with a resiliency that is becoming a new norm, airlines continued to modify and adapt to this ever-changing environment in an effort to maintain, if not improve, profits. As the second half of the year unfolds, the North American airline industry is still expected to be profitable in 2012, albeit with some airlines faring better than others.

Airlines are overcoming some of the economic hurdles by constraining capacity, utilizing existing assets more productively, reducing fixed costs, and finding new revenue streams. Airlines have placed a renewed emphasis on product improvement and modernization through fleet renewal as competition for business travel increases. At the same time, airlines are carefully watching every dollar that they spend on capital investments and are monitoring their debt loads, continuously looking to restructure and reduce existing debt to improve their financial performance and strengthen their balance sheets.

Chart 1: Global Economic Recovery Stalling; Much Depends On EU Situation



Source: IMF, July 2012

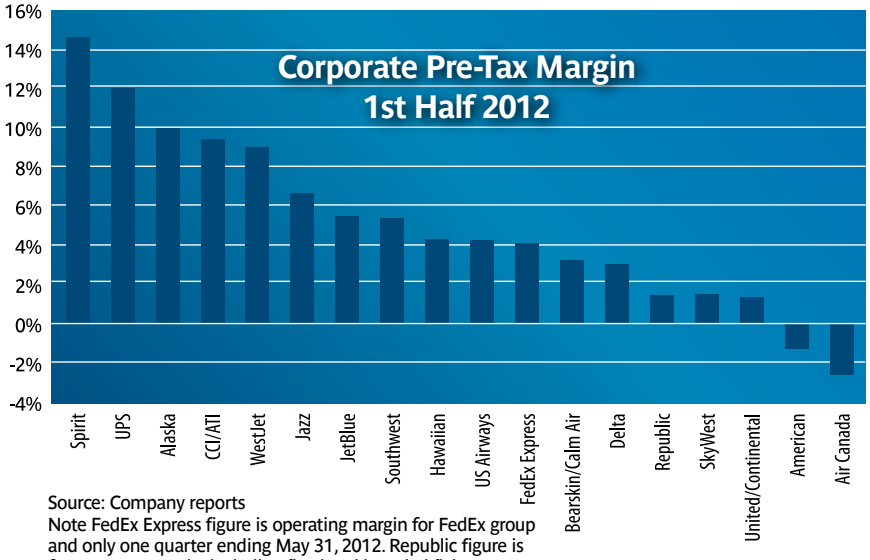
Economic outlook

The U.S. economy continues to grow at a snail's pace. The housing market, although finally showing some signs of improvement, is still weak, and consumer spending remains sluggish, with confidence low and households still focused on reducing debt. Without improvements in consumer confidence and spending, the labor market is unlikely to improve. While exports have been a bright spot in the recovery, weak growth in U.S. trading partners' economies and a strengthening dollar are likely to curb trade.

Global economic events, particularly in the European Union, are the predominant threat to the airline industry at this time. The current economic outlooks call for the U.S. gross domestic product (GDP) to grow just more than 2 percent in 2012, with only moderately higher growth in 2013 at 2.3 percent. In Canada, economic growth is expected to reach 2.1 percent in 2012 and 2.2 percent next year. As a frame of reference, the airline industry typically needs at least 2 percent economic growth to generate profits, and the economy needs more than 4 percent to generate job recovery.

While modest economic growth is forecast, downside risks to the economy are ever-present. A further deterioration of the European debt crisis could lower demand for U.S. goods and hurt financial markets. In addition, the U.S. is facing a fiscal cliff at the end of the year. In January 2013, $1.2 trillion in

Chart 2: Respectable Profit Margins For Most Airlines



Source: Company reports
Note FedEx Express figure is operating margin for FedEx group and only one quarter ending May 31, 2012. Republic figure is for corporate results including fixed and branded flying.

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automatic spending cuts are set to begin, while a series of tax cuts enacted under President George W. Bush and extended under President Barack Obama, as well as temporary reductions to payroll taxes, are scheduled to expire. The Congressional Budget Office has estimated that the effect of the fiscal cliff could result in a 3.9 percent reduction in the growth rate of the GDP next year.

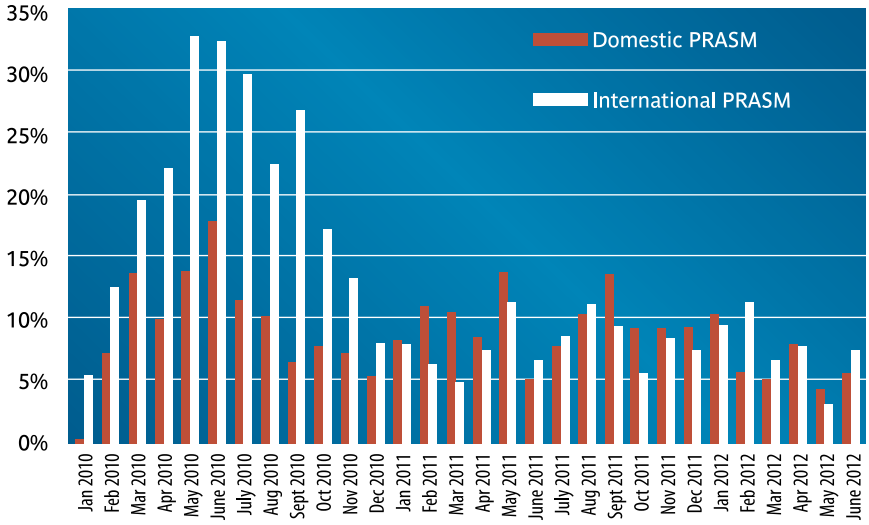
Industry results

The strong airline revenue environment that occurred in 2011 has slowed during 2012. Despite this slowdown, however, the airline industry continues to experience sustained unit revenue growth, stemming from continued capacity constraint. The fuel price spike seen in the first quarter ebbed considerably in the second quarter, giving airlines a chance to generate modest returns in the first half of the year. Year to date, the industry has earned more than $2 billion in pre-tax profits, nearly as much as it earned for the whole year in 2011.

Passenger industry

Various factors, including revenue trends, capacity constraint, and fuel costs, are contributing to the industry's continued positive performance, despite the slug-

Chart 3: PRASM Decelerating; Caution For Remainder of 2012



Source: Morgan Stanley, ATA

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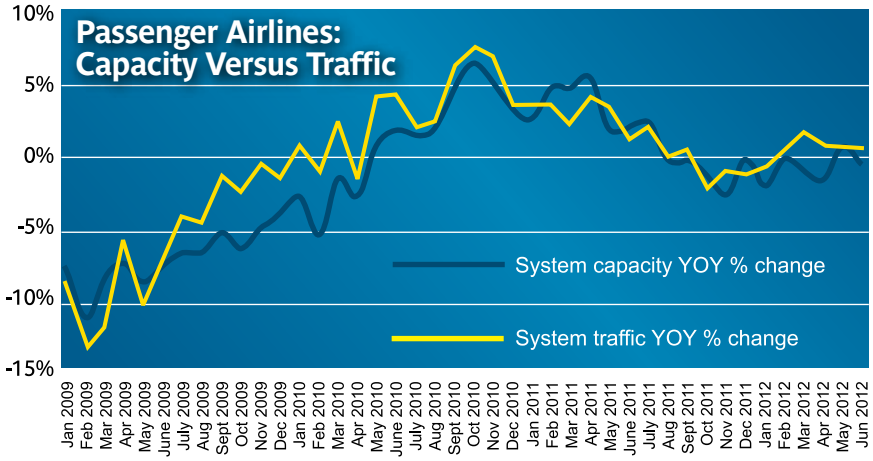
Chart 4: Airlines Maintaining Capacity Discipline Has Helped Pricing



Source: ATA Traffic Reports. Data for February 2012 normalized.

gish economy. As seen in Chart 3, domestic and international passenger revenue per ASM growth (PRASM) continues on a year-over-year basis. While the gains seen so far in 2012 have been at similar levels as those seen in 2011, these gains are noticeably decelerating. In 2011, the industry instituted 11 domestic fare hikes by mid-year. So far in 2012, only four such fare hikes have taken place. Note that the 2010 growth rates were significant, but that growth rate represented the recovery from the throes of the 2009 recession. As the industry moves into the third and fourth quarters of 2012, continued capacity constraint will be vital to maintaining reasonable rates of PRASM growth.

Capacity and costs

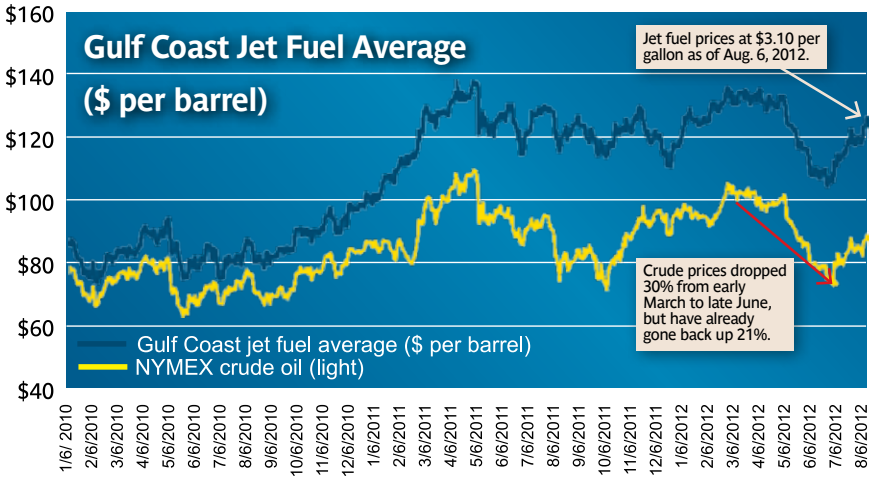
The ability to manage capacity effectively has become critical to the airline industry for a number of reasons. As aircraft ownership is among the largest fixed costs, fleet management can have a significant effect on profitability. Additionally and more importantly, by ensuring that demand (traffic) exceeds supply (capacity), airlines can maintain greater pricing power and avoid fare wars, which deteriorate yields and profitability. In 2011, airlines were able to maintain high load factors and aircraft utilization in passenger markets, which improved cash flow and profitability—even in the face of high fuel costs and weakening economic growth. To date in 2012, the industry is still seeing the same positive results, particularly with fuel costs declining.

Capacity discipline is expected to continue into the near future. As seen in Chart 4, U.S. industry capacity is remaining essentially flat, growing at only 0.3 percent. Major airlines are actually reducing capacity on a year-over-year basis. Even Southwest, which has generated strong growth rates for so long, has announced that it will not be adding capacity this year. In addition, airlines' ability to coordinate capacity with their alliance partners may become a bigger factor, as airlines look to recapture the traffic from capacity reductions made to secondary cities by redirecting passengers over their partner hubs.

Fuel

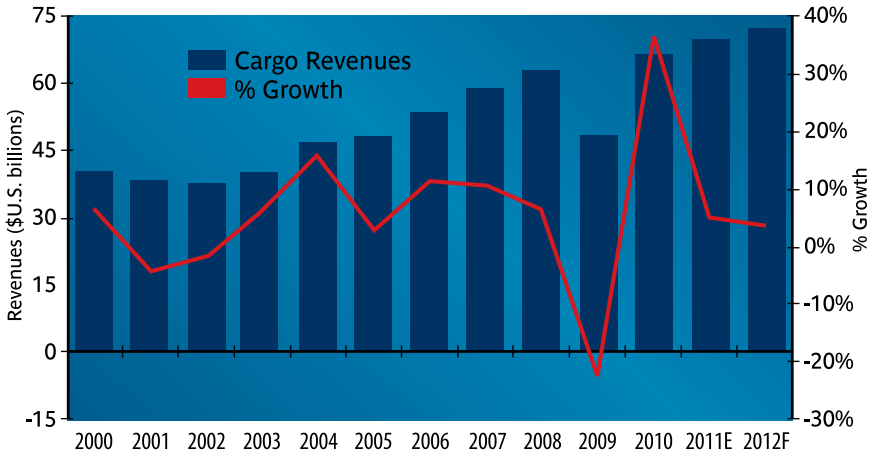
While revenue has been one of the positives for the airline industry, volatile fuel prices remain a real challenge and risk for all segments of the industry. Fuel prices continue to fluctuate significantly.

Chart 5: Despite Recent Easing, Jet Fuel Remains Industry Concern



Source: EIA, NYMEX

Chart 6: Global Cargo Revenue Growth Continues To Decline



Source: ICAO, IATA Cargo Analysis, June 2012

In addition to the effect of crude oil prices on the airline industry, it's facing volatile crack spreads. Crack spreads (the cost of refining crude oil into jet fuel) have increased significantly in recent months. Airlines have had to respond with more tactical hedging strategies to address these volatile costs.

In March, crude prices were up 42 percent from the low in October 2011. By the end of June, fuel had dropped by 28 percent from the March high. Only a month and half later, crude prices were back up 21 percent.

As the economy has struggled, particularly in Europe, fuel prices have decreased. However, since falling to as low as $2.63 per gallon in the second quarter, jet fuel prices have started to rise again and are back above $3 a gallon. Over the last few years, the industry has been able to pass higher fuel prices on to the passenger, but that may not be the case in the future if a spike in fuel prices results from geopolitical tensions or refinery issues, as opposed to economic strength.

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Regional industry

With little to no growth on the horizon, aging fleets and workforces, and a maturing business model, the regional market is in the throes of further consolidation and restructuring. Delta recently announced the closing of its subsidiary Comair, Pinnacle has filed for bankruptcy and is shutting down its Colgan operating unit, and American Eagle is in the process of restructuring due to its parent company's bankruptcy filing. And SkyWest (the parent company of SkyWest and ExpressJet) is still focusing on integrating Atlantic Southeast and ExpressJet.

These moves all coincide with the fact that the 50-seat jet is being driven out of regional markets. In today's environment, the operating economics of the 50-seat jet have become less attractive. High fuel prices and increased maintenance costs for these older aircraft are outweighing their relatively low ownership costs.

Delta, for example, presently operates more than 300 50-seaters. However, it's looking to reduce that number to 125 over the next several years. As part of that effort, Delta recently reached an agreement with SkyWest to replace 66 50-seat airplanes that SkyWest currently operates with 34 larger regional aircraft.

Meanwhile, Canadian regional operator Jazz is in the process of replacing its entire fleet of CRJ100 jets with Q400 turboprops.

Some analysts believe the 50-seat jet will be gone from the skies as early as 2018, while the FAA indicates in its 20-year forecast that these airplanes will cease to operate by 2032.

Cargo industry

After a dismal 2011 and first quarter 2012, air freight volumes have seen

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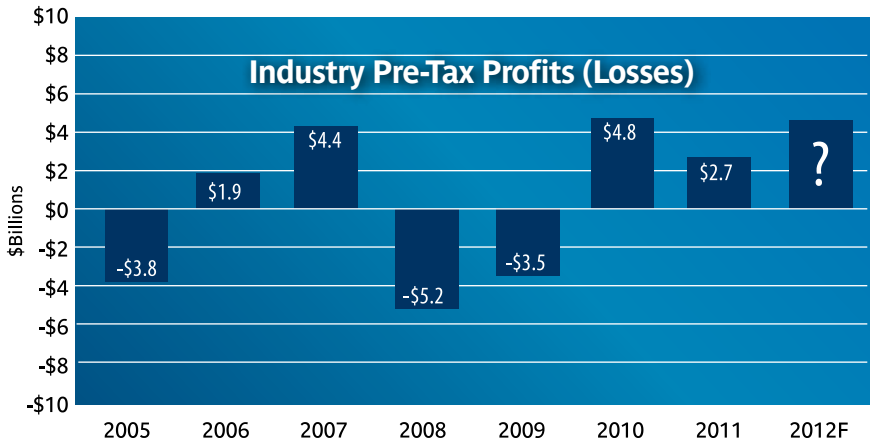
Chart 7: Despite Economic Fears, Industry Still Expected To Be Profitable in 2012



Source: ALPA E&FA analysis of company filings 2005 – 2011 (Alaska, American, Delta, JetBlue, Southwest, United/Continental, US Airways), various analyst forecasts for 2012.

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a minor recovery. An improvement in business confidence and a slight increase in world trade have supported the freight markets recently. Seasonally adjusted world freight volumes in June were up by more than 3 percent compared to the low point in the fourth quarter of 2011.

While freight volumes are up slightly, there is a concern that the cargo market could soon face an overabundance of capacity. According to Air Cargo Management Group, 213 new-built widebody freighters were on order as of May 2012. This represents about 21 percent of the current widebody freighter fleet.

Couple the growth of the widebody freighter fleet with an influx of belly space from deliveries of large numbers of widebody passenger airplanes in the next few years and the main-deck freighter value proposition seems to become more difficult. Deliveries of new twin-aisle airplanes with belly hold capacity will increase capacity by almost 60 percent in 2012 compared to 2011.

Maintaining asset utilization will be a challenge. In fact, several cargo carriers have been parking airplanes, a strategy that only passenger airlines had instituted in the years following September 11 and after significant surges to fuel prices and the global economic recession of 2009. FedEx has announced several measures to face the ongoing slowdown in its business segment, including retiring 24 freighters.

Outlook

While current forecasts suggest the airline industry will post its third straight annual profit this year, the middle- to longer-term outlook remains uncertain. While airline revenue is still strong and many airlines have sufficient liquidity on hand, the situation can change quickly given the economic landscape and the variety of external factors that can affect the industry or fuel prices. Capacity constraint has served the industry well for the past few years and will be key in the future. Airlines will need to be cautious with any plans to add capacity.

While the industry as a whole is expected to make a profit in 2012, this will be likely concentrated at mainline airlines. The regional industry will continue to struggle through the rest of 2012 as it undergoes major structural changes, consolidation continues, and mainline airlines look to divest themselves of smaller jets. In the cargo industry, the largest airlines are expected to continue to post profits, but margins will be pressured by anemic growth and increased competition.

All in all, the airline industry as a whole continues to perform relatively well given the poor economic backdrop. As revenue growth trends slow and fuel prices creep back up, the structural changes that the industry has made over the last several years will continue to be tested and will provide invaluable insight into the industry's ability to weather future downturns.