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

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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

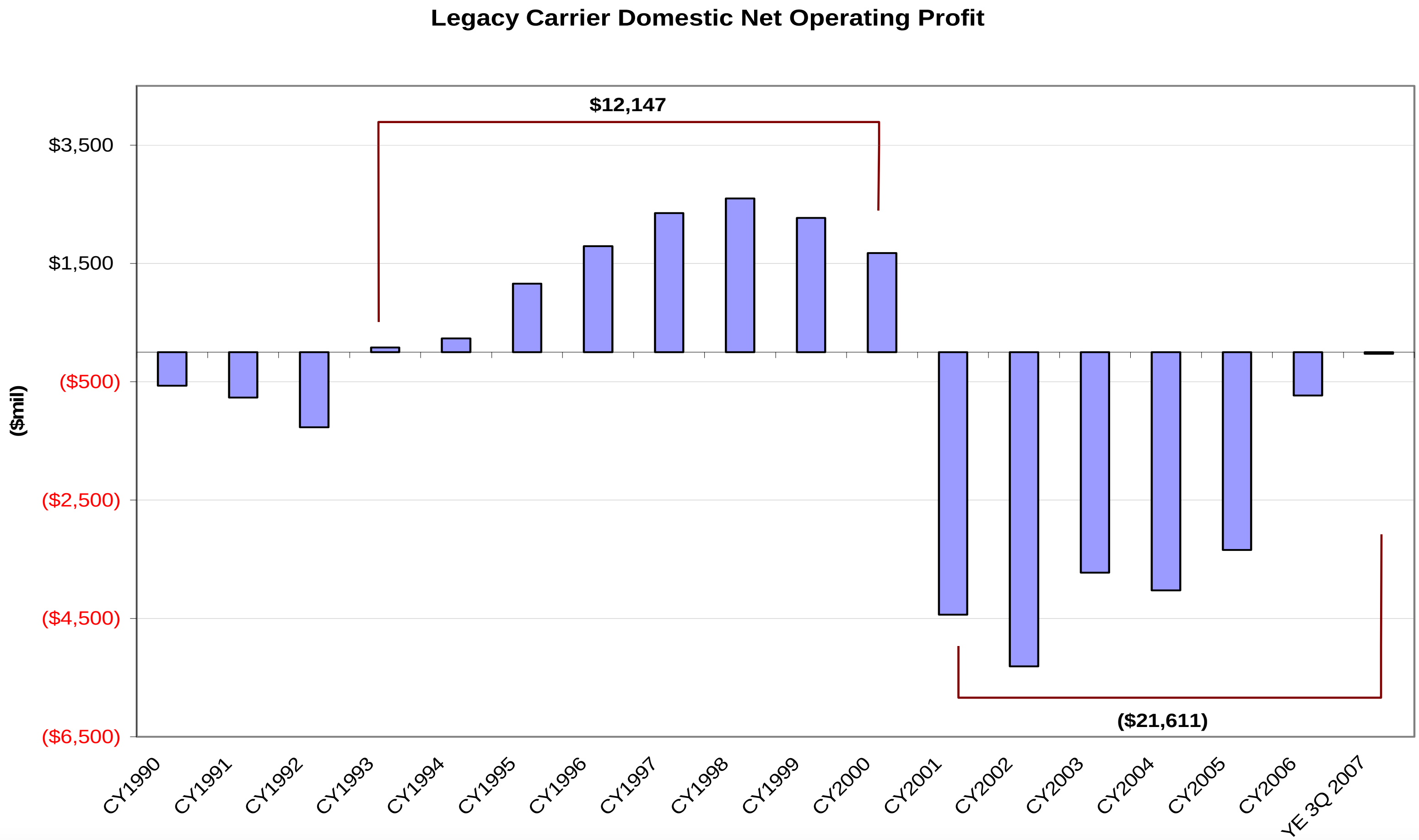
# Why Is The FAA Interested In Load Factors?

- 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

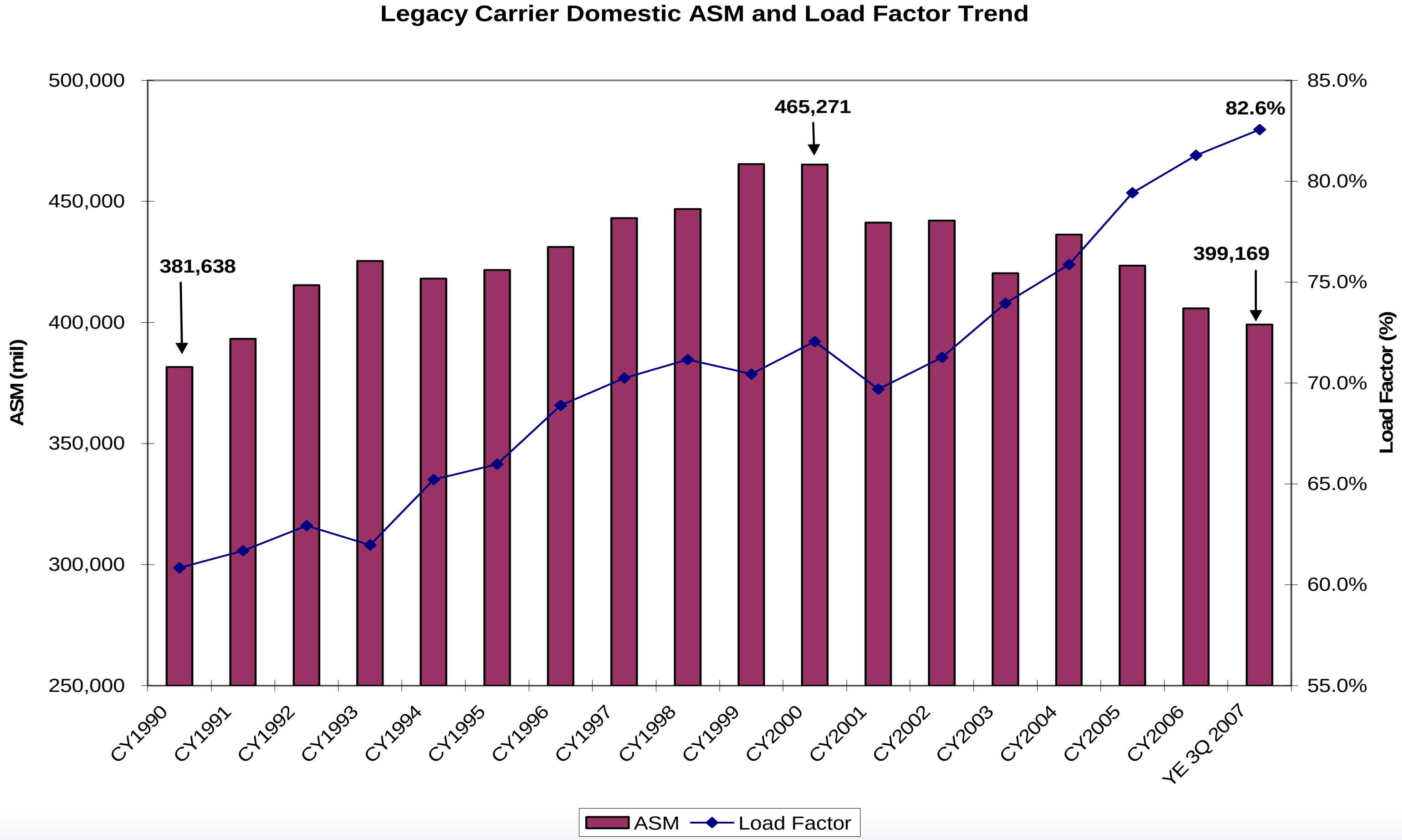
# Basic Definitions

- 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 = (EBIT + Net Interest) * (1-Tax Rate)
  - Capital = (Assets) – (Current Liabilities) + (STD) + (A/C Op Leases * 7)
- Focus of Analysis → Big Six Legacy Carrier Domestic Divisions
  - AA, AS, CO, DL, NW, UA
  - Form 41 filings

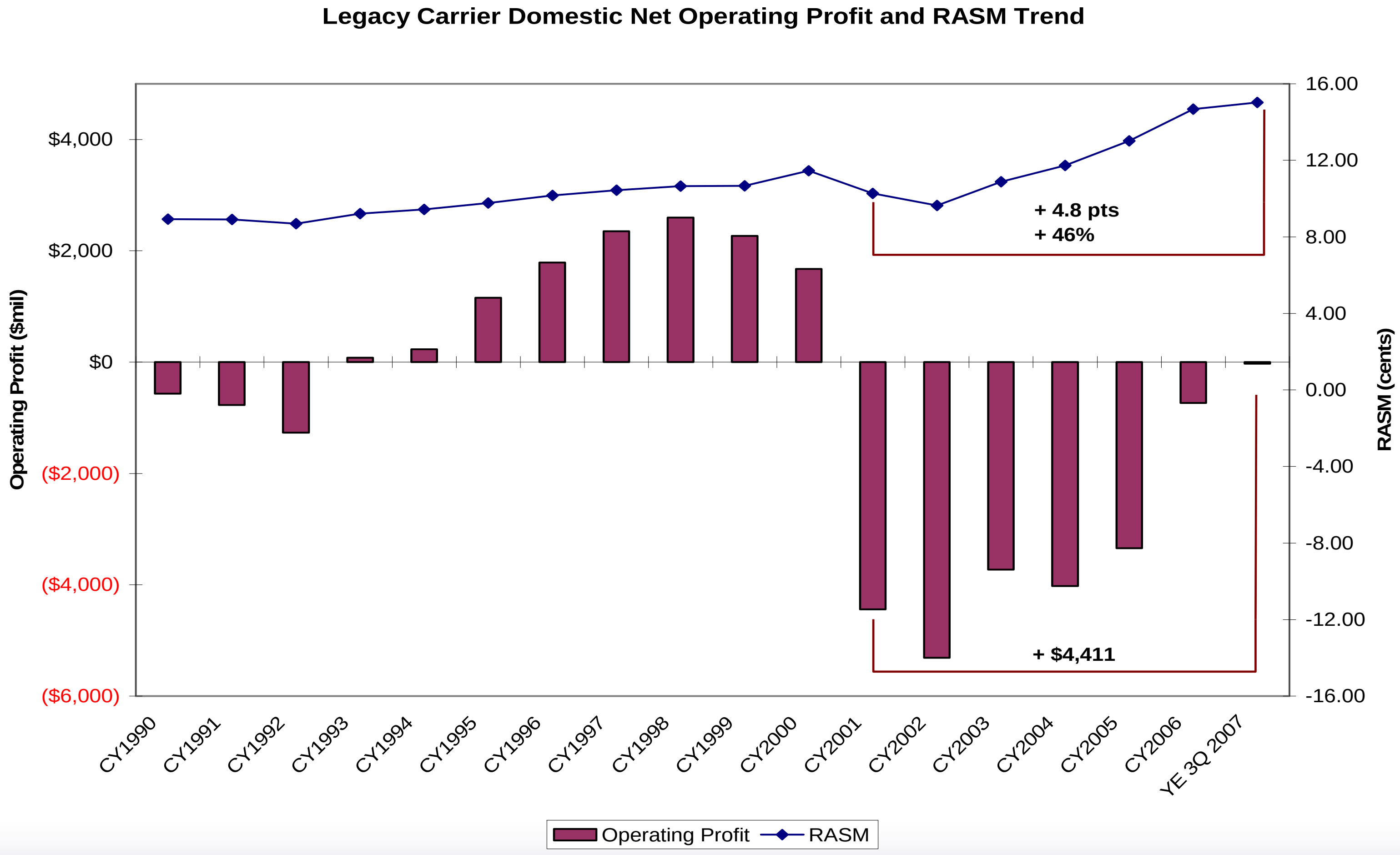
# Legacy Carriers Attained Break-Even In 2007 Looking to Enter a New Profit Cycle



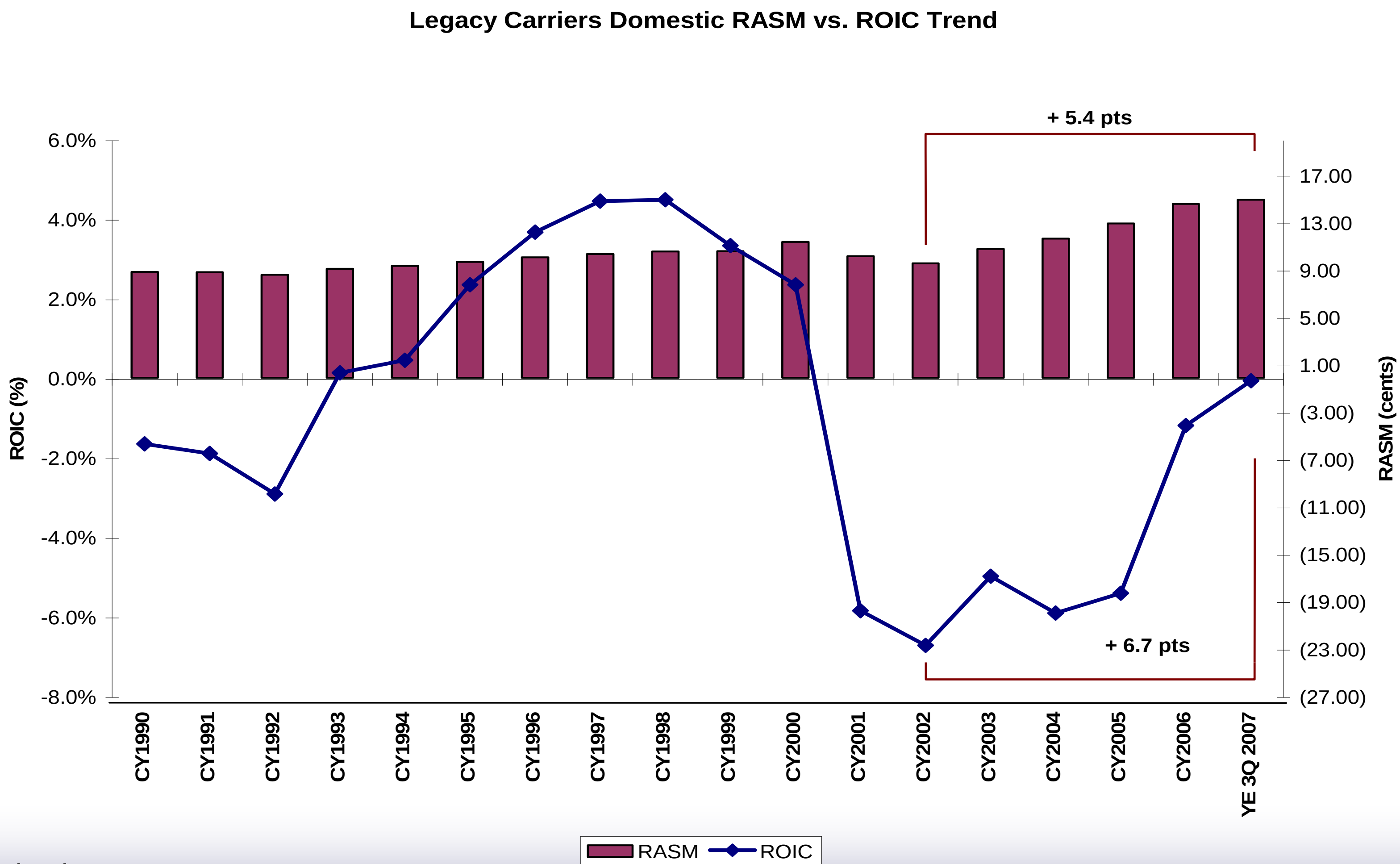
# Passenger Load Factors Have Reached Historically High Levels On 14.2% Decrease in ASM Since CY2000



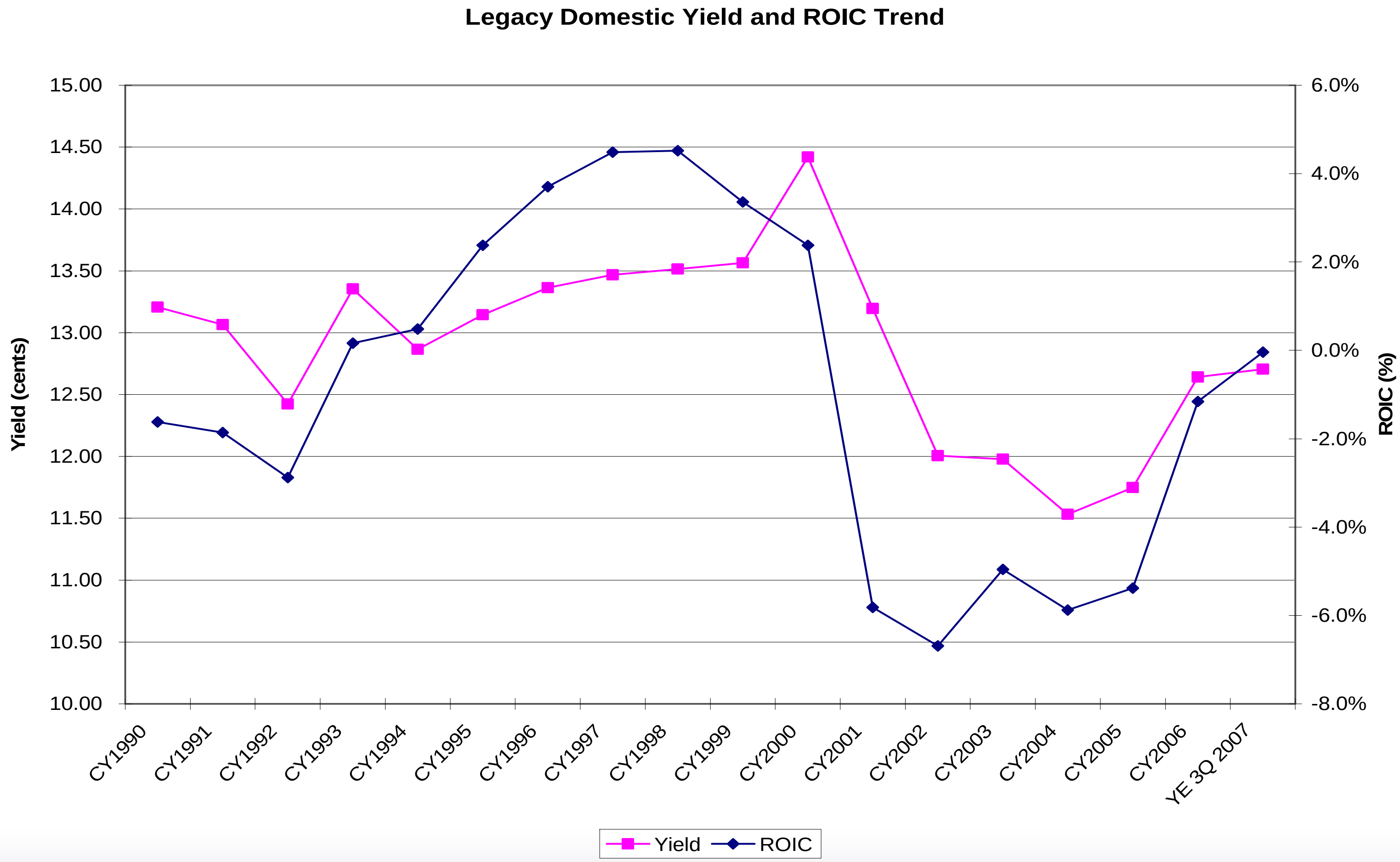
# The Latest Industry Profit Turnaround Reflects Improvements in RASM



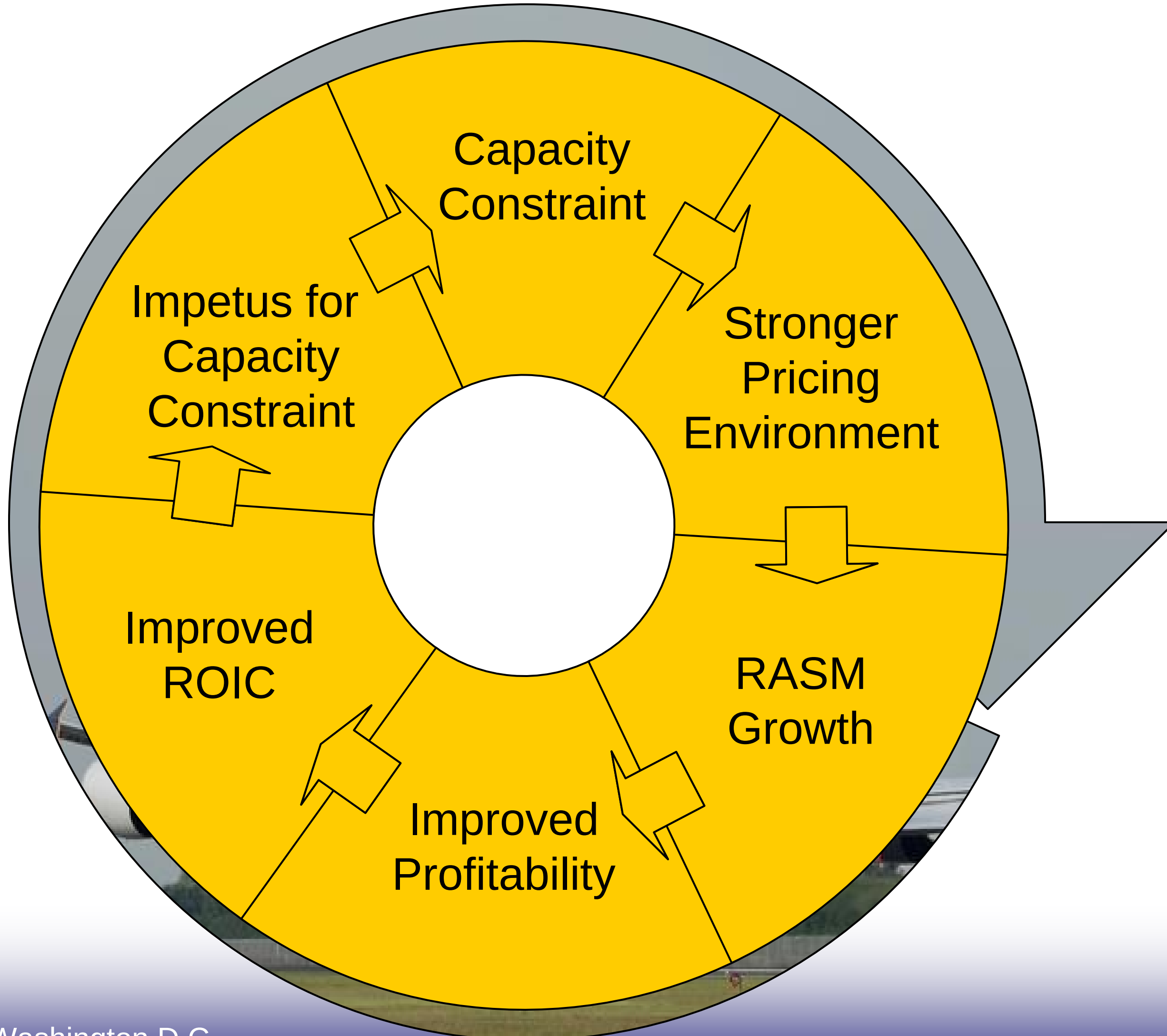
# Since CY2000, as RASM Goes, So Does Return on Invested Capital



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

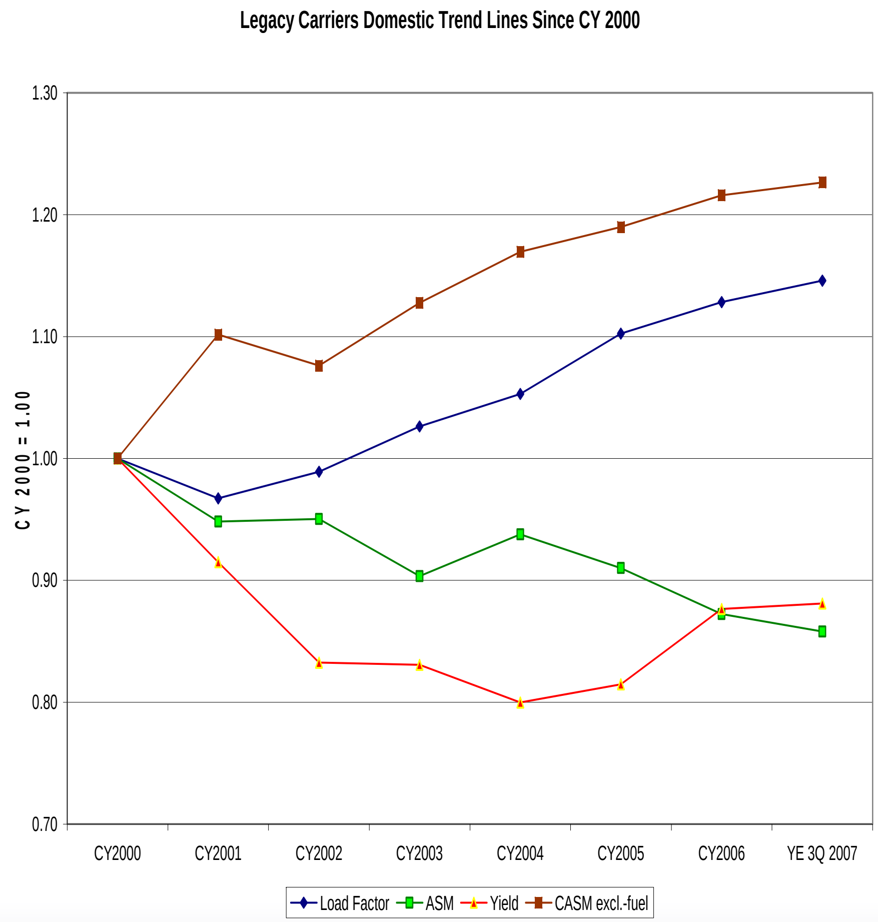


# Carriers Attempt to Pursue a Virtuous Cycle of Capacity Constraint



# 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 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

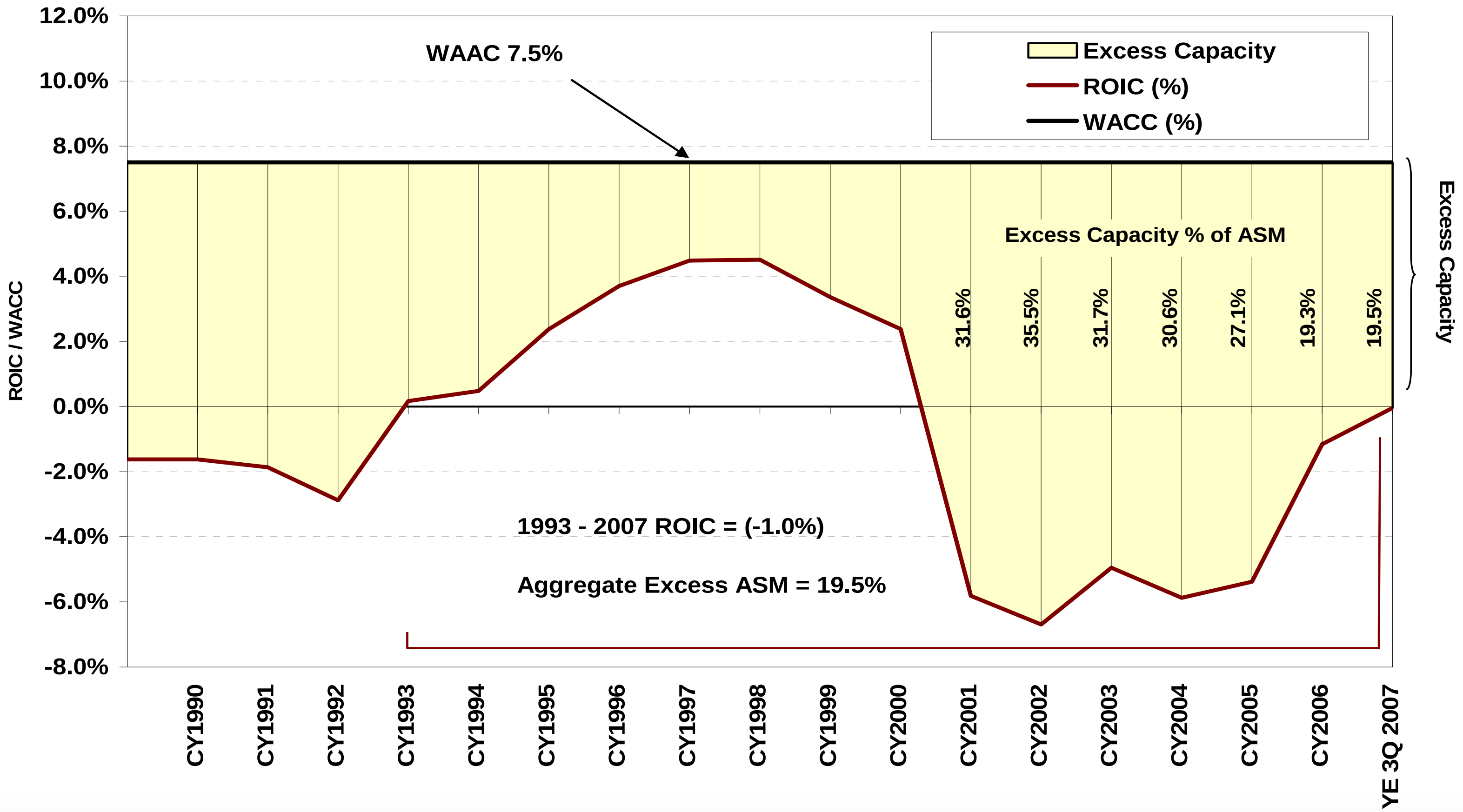
| Domestic Legacy Carriers | CY2000 | YE 3Q 2007 | Variance | Percent |
|---|---|---|---|---|
| Passenger Revenue (mil) | $48,342 | $41,868 | ($6,475) | -13.4% |
| Net Operating Profit (mil) | $1,672 | ($28) | ($1,701) | -101.7% |
| Net Op. Profit @ CY2000 Fuel Price (mil) | $1,672 | $7,982 | $6,310 | 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

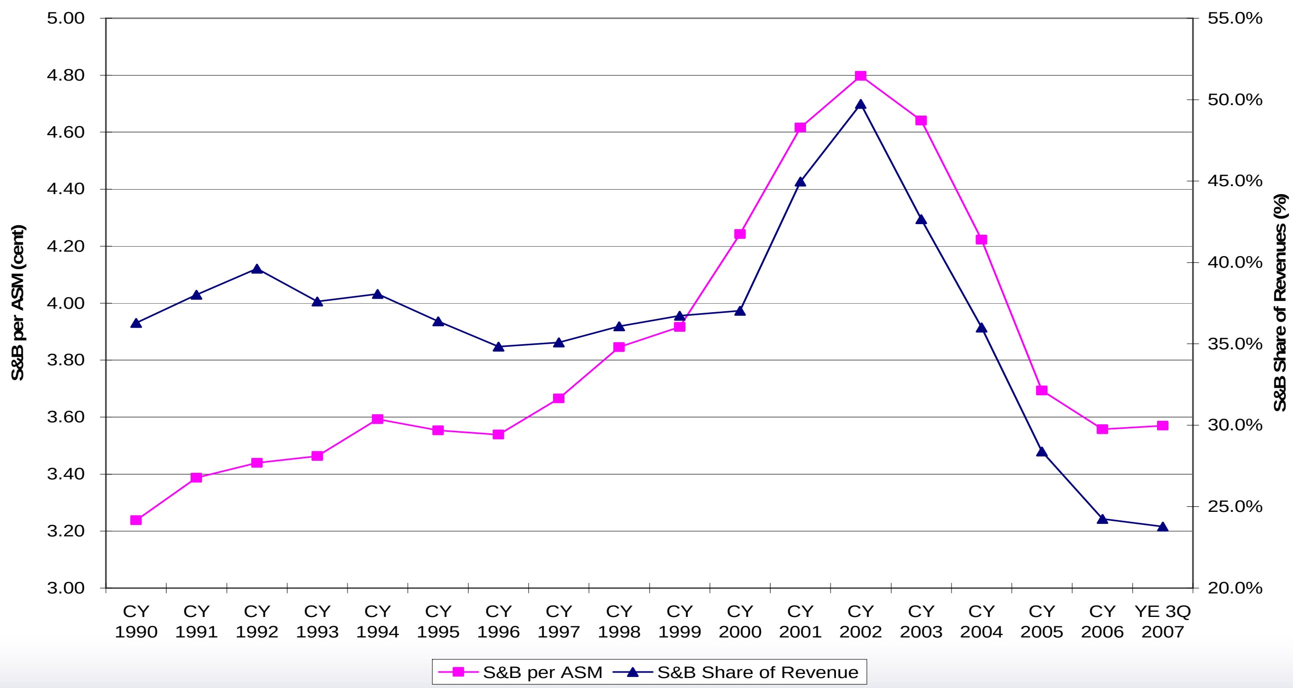
- Domestic Legacy fares would increase 21.8% ($30 per passenger) at current load factors
- With price elasticity of demand at 1.10 passenger revenue would decrease (-2.0%)
- Operating costs would also decrease (-18.0%) → cost structure issues and further cost reduction requirements?

| 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

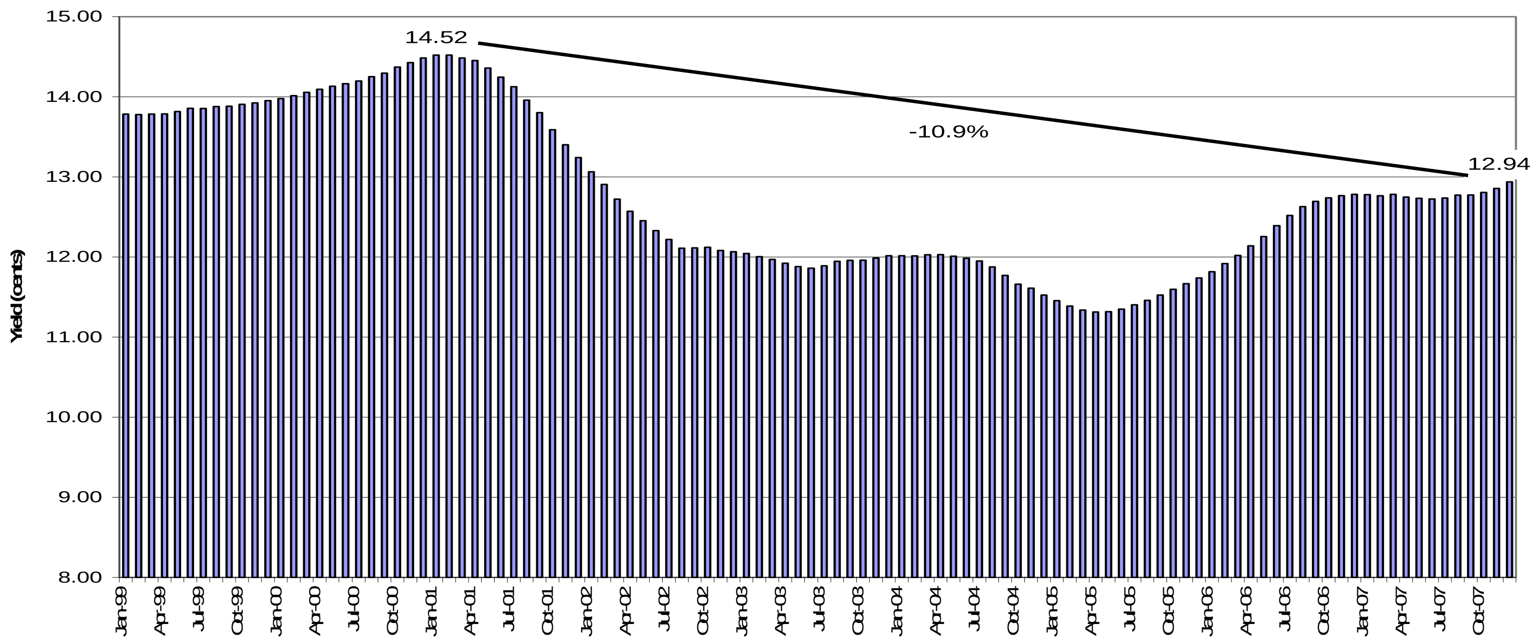
**Legacy Carriers Domestic Labor Cost Trend**



# 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

Mainline Domestic Yield Trend -- Rolling 12 month average



# 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