



Airline Strategies for VOLATILE ENVIRONMENTS

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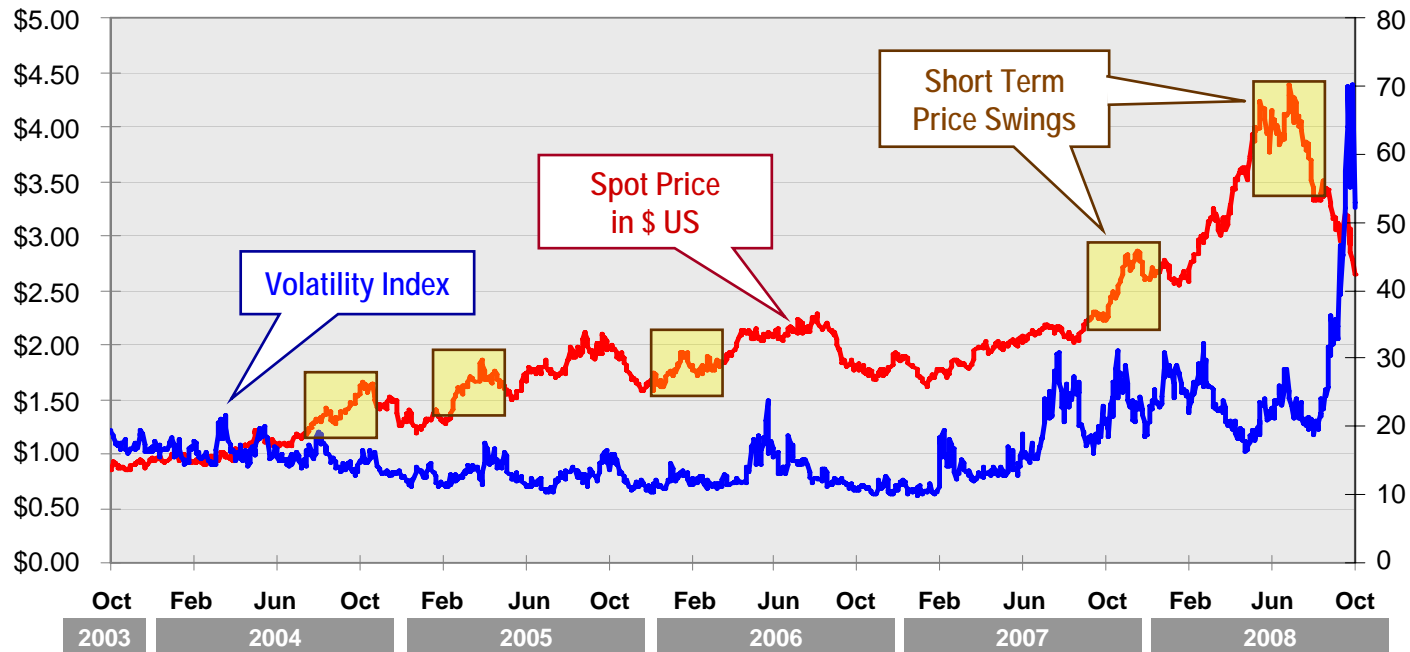
**Aircraft and Engine Finance
and Leasing Conference USA
22-23 October 2008**

Airlines increasingly need to manage every dimension of their business to address volatility

- ◆ **Levels of important airline inputs and demand appear to be moving up and down with greater frequency and dispersion than they have before**
- ◆ **Historically, the airline industry has demonstrated the ability to adapt to both short-term and long term changes in prices**
 - Successful adaptations have addressed step-changes in the competitive environment rather than volatility *per se*
 - While the industry as a whole survives, individual airlines may not survive
- ◆ **To profit amidst today's rapid and unpredictable movements, airlines will need to adopt new strategies and processes in every dimension of their business, affecting the balance sheet as well as the income statement**
 - Commercial, operational and financial decisions can all mitigate volatility
 - Strategies must reach beyond financial hedges to encompass all aspects of airline management

Airline inputs are increasingly volatile and dispersed – *despite availability of financial products to manage volatility*

Rotterdam Jet Fuel Price per Gallon & Volatility Index



Fuel: 45% higher than two years ago in dollars

Currency: USD up 25% against Euro in 3 months

Credit: Volatility Index (“VIX”) – “Fear Gauge” – up nearly 3 times its historical average

Interest: TED Spread rose from 1.04 to 4.63 bps between mid-Sept. and mid-Oct.

Meanwhile, air travel demand is dipping into one of its periodic downturns

“We have seen that with the turmoil in the financial markets, the demand out of New York is softening more than other parts of our domestic system. As we look at our advanced booked load factors out of New York, it's weaker than the rest of the system.”

Willie Walsh, CEO of the British Airways,
September 17, 2008

“This industry is in crisis – a deeper, more protracted, more fundamental crisis than 9/11, the Gulf War or any of the previous shocks that have beset the industry since the age of mass air transport began in the 1970s.”

Tom Horton, CFO, American Airlines,
October 15, 2008

“We’re already seeing cancellations ... Occupancy has been weaker in October, traditionally one of the strongest months.”

Vijay Dandapani, COO Apple Hotel Chain,
October 17, 2008

“As we approach 2009 with a sober economic outlook ... travel managers are coping with the unpredictability of fuel costs, weak financial markets, and the global credit crisis.”

Kevin Maguire, President, National Business Travel Association,
October 20, 2008

Airlines have shown increasing volatility of earnings over time despite consolidation

Oil Shock/
Recession

Gulf War/
Recession

Gulf War/
Recession/9/11

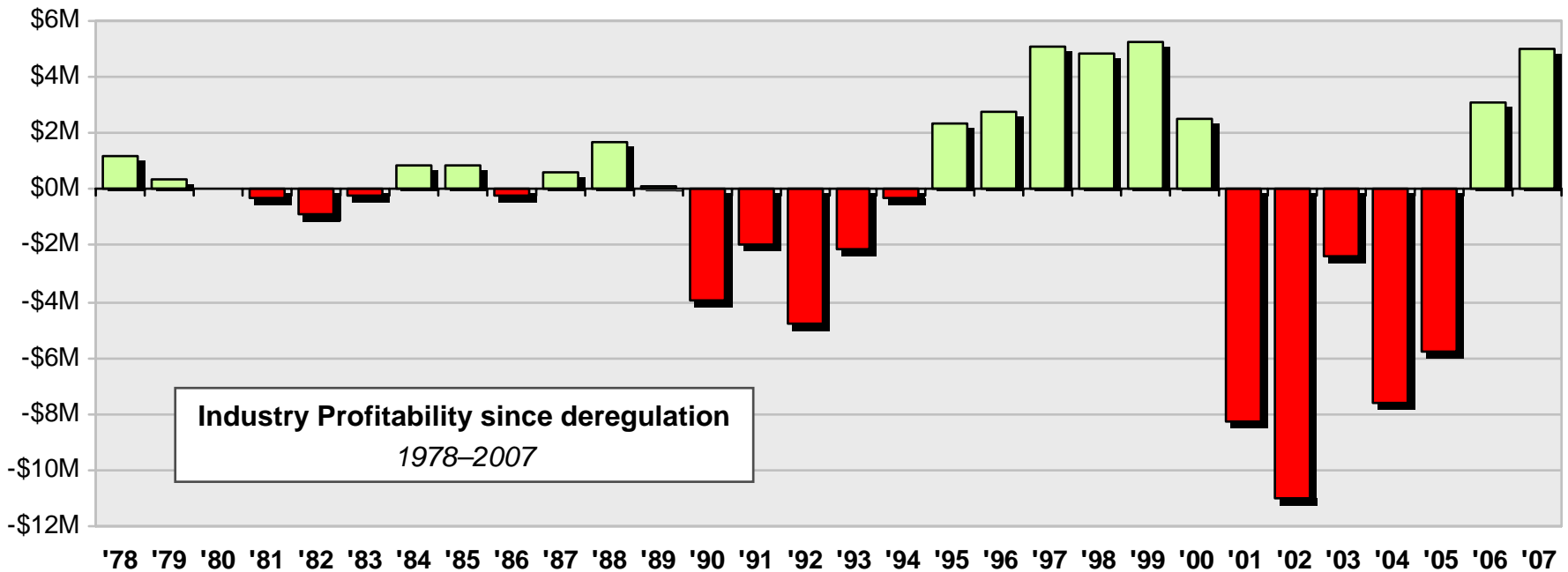
Profits \$1.2B --- (\$1.1B) --- \$3.8B --- (\$8.0B) --- \$18.0B --- (\$24.4B) ---

Network Carriers 20

15

10

5

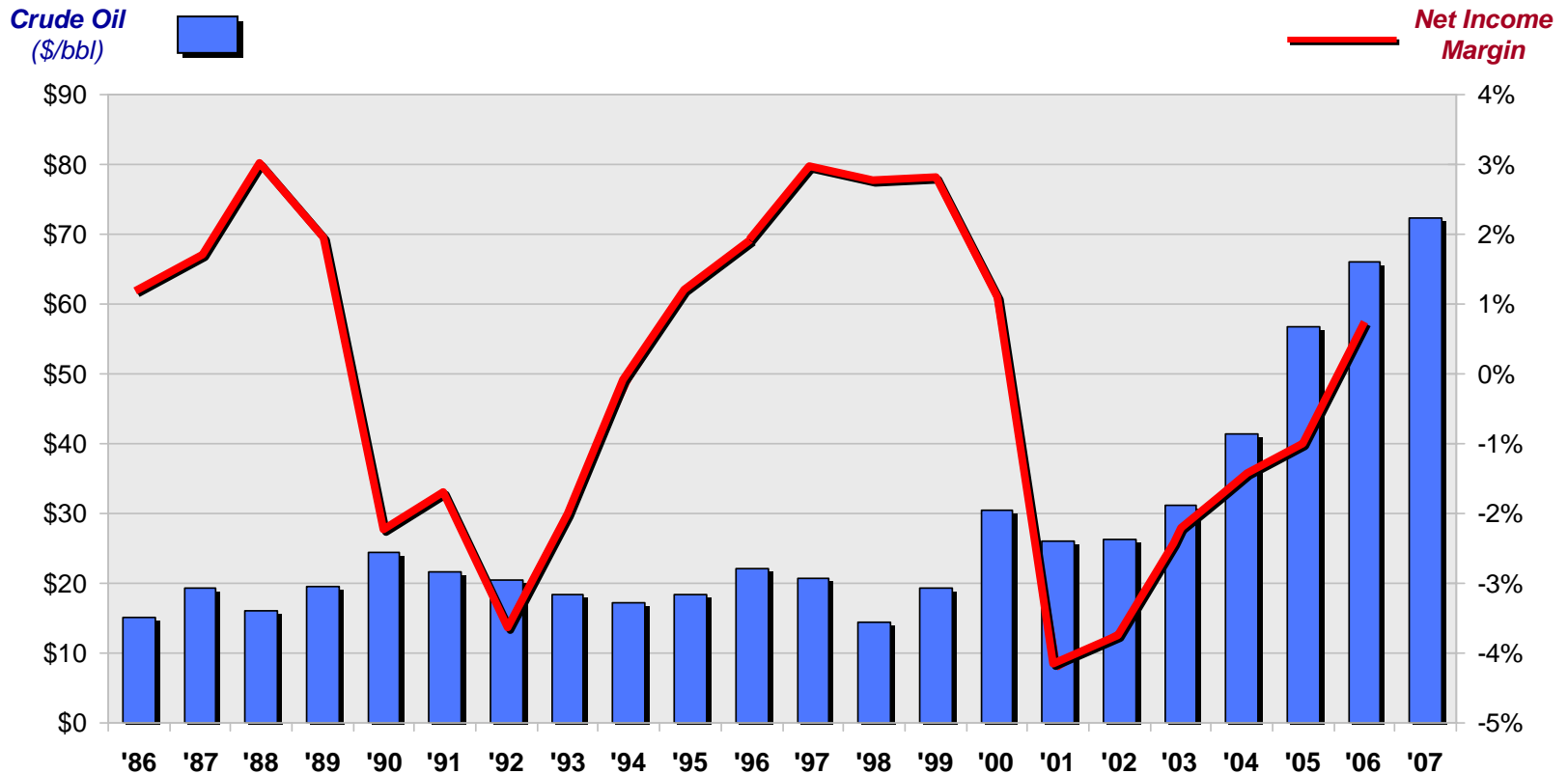


Source: <http://www.airlines.org/economics/finance/Annual+US+Financial+Results.htm>

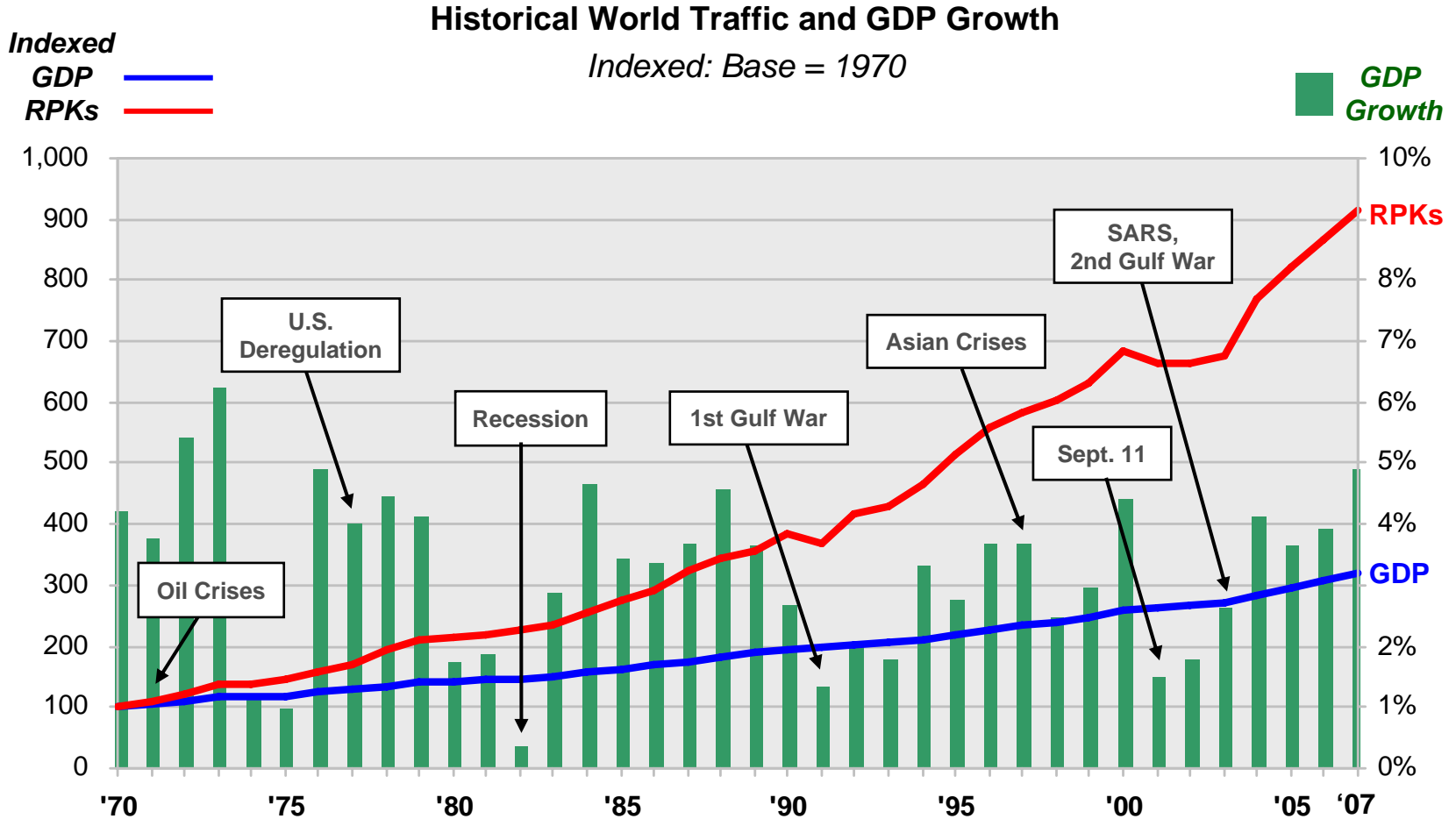
Post-1992 results exclude bankruptcy-related restructuring charges and fresh-start accounting gains. 2001 and 2002 include 9/11/01-related compensation remitted to carriers under P.L. 107-42. 2003 includes security cost reimbursements remitted to carriers under P.L. 108-11.

The airline industry has proven its ability to manage external shocks – *net income is not a function of fuel prices*

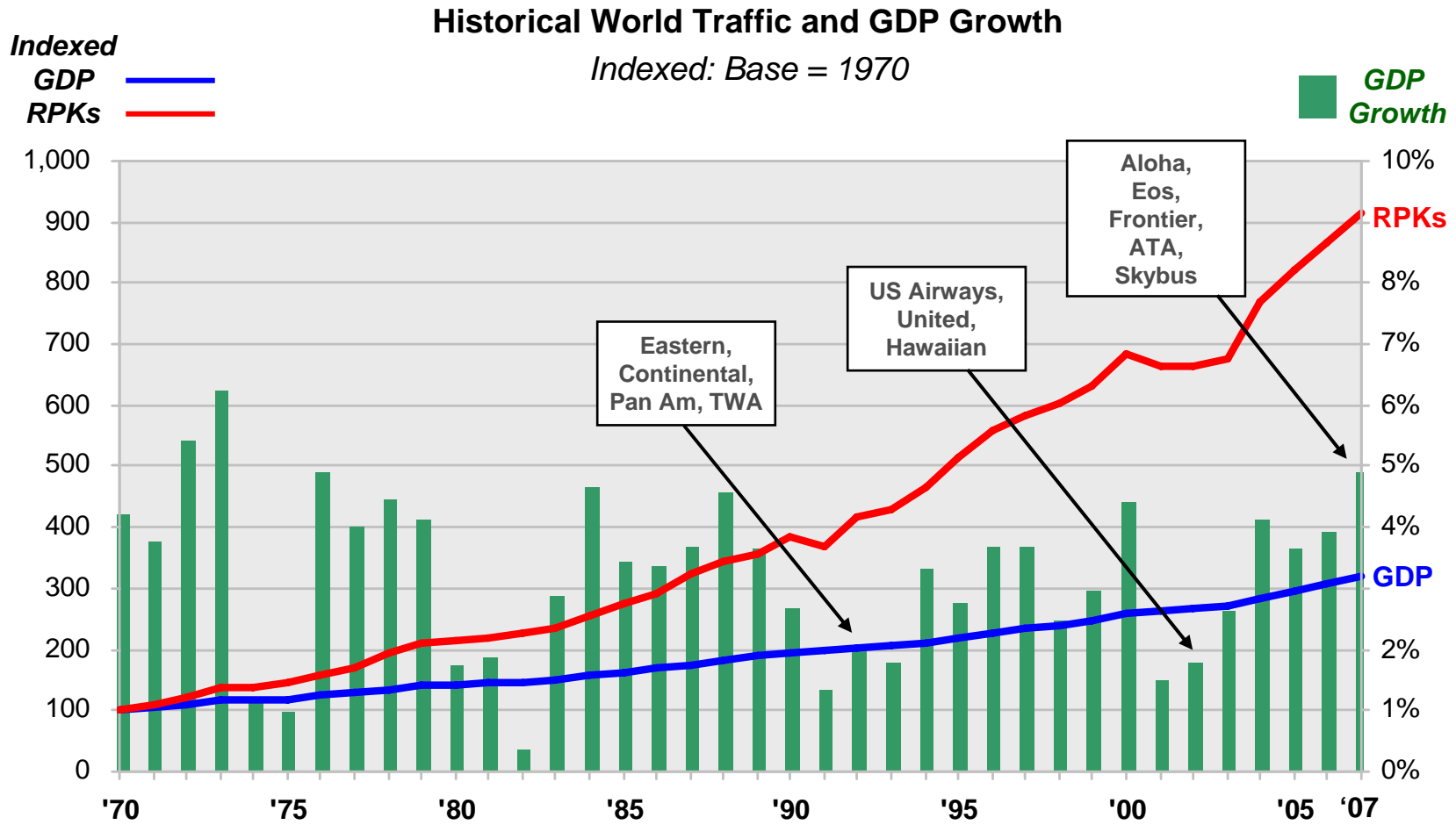
Crude Oil Prices and Airline Net Margins
1986–2007



Over the long term, the airline industry will adapt to cost and demand shocks...



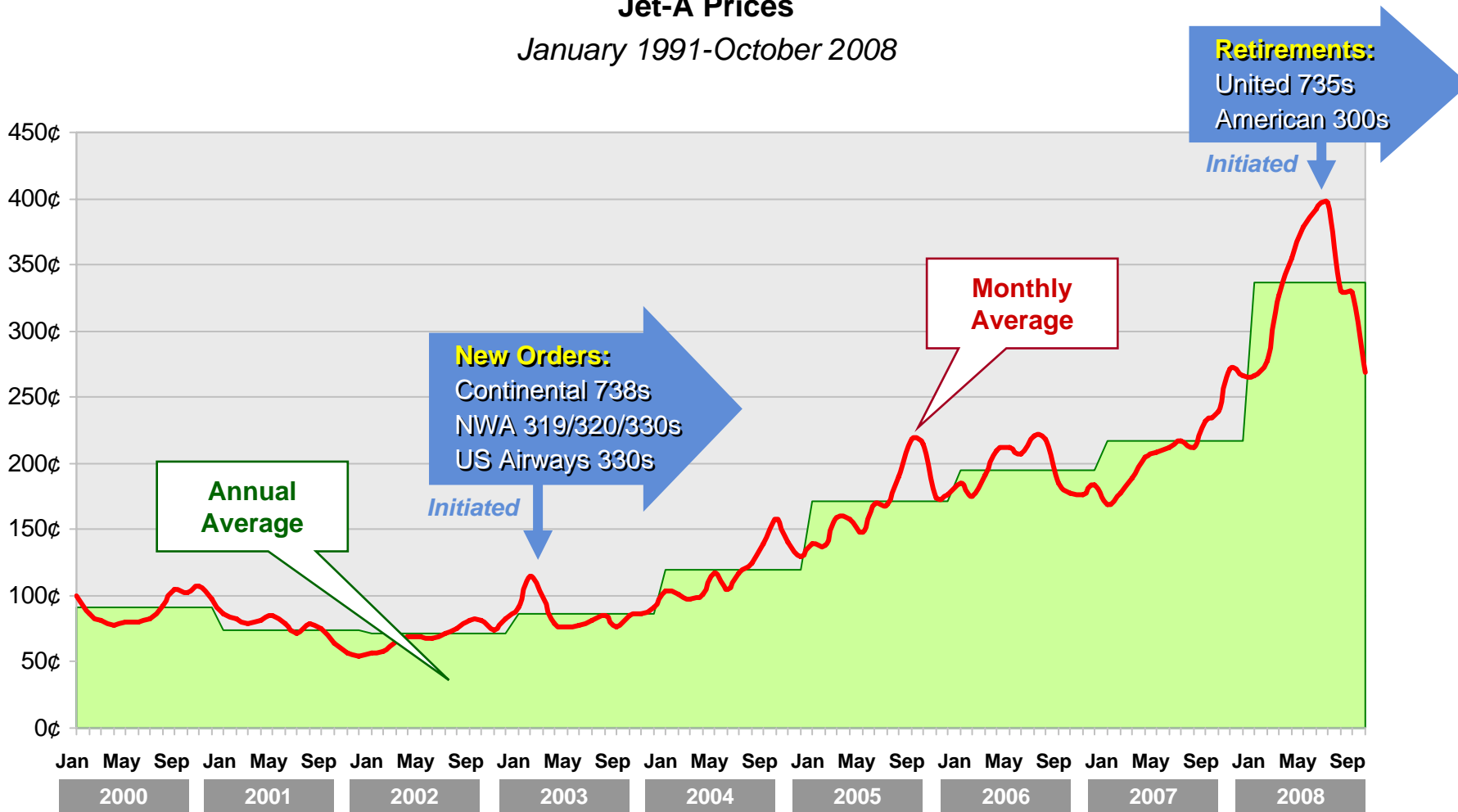
...Even as individual airlines fail



Carriers extrapolate from short-term price movements to make long-term decisions

Jet-A Prices

January 1991-October 2008



Source: Energy Information Administration (New York Harbor Jet-A closing prices, 1991-2008)

There are a number of effective strategies for managing volatility

◆ Cash

- Increased unrestricted cash
- Manage credit card holdbacks

◆ Financial and Commodity Hedges

- Fuel: *Advanced Delivery Commitments, Collars, Caps*
- Currency: *Derivatives & Options, Point of Sale Hedge, Denomination Hedge, SDR Linked Payments*
- Interest rates: *Options, Swaps, FRA's*

◆ Commercial Strategy

- Network
- Point of Sale
- Consolidation and alliances

◆ Fleet Mix

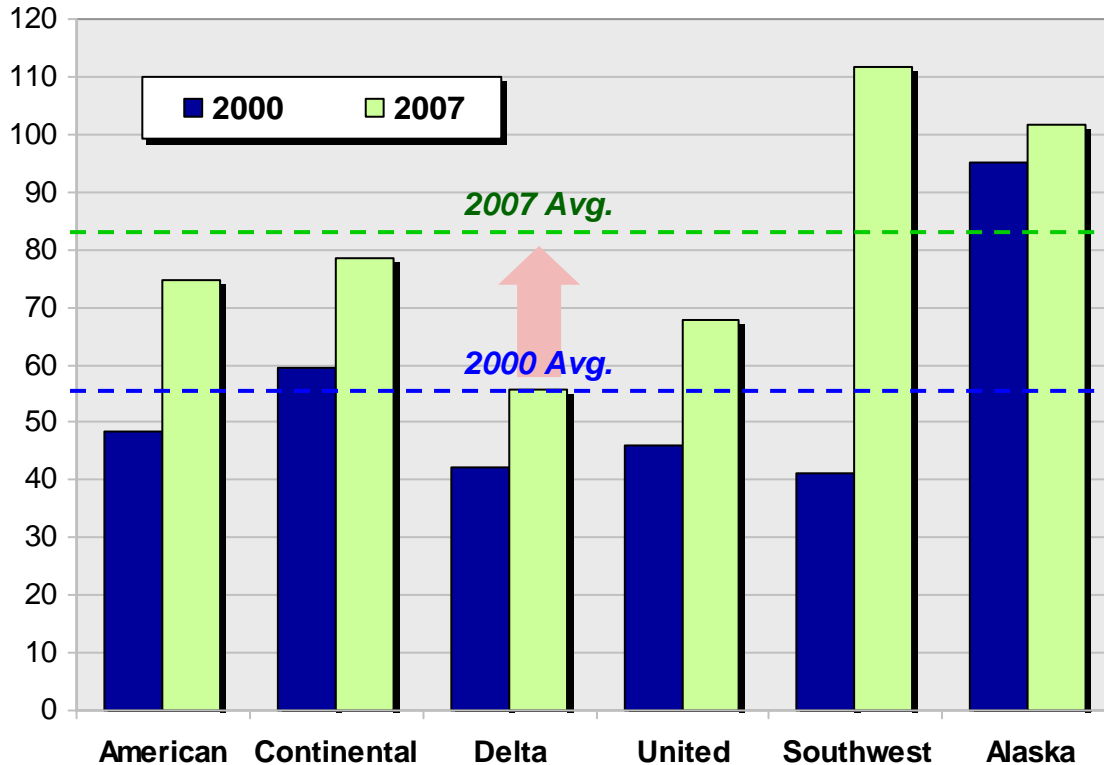
- Lease vs. Own
- Old vs. New

1. **Cash:** Most carriers have increased their cash balances, at a cost of almost \$1 billion per year for the large US carriers

Carrier Cash Cushions

2000 vs. 2007

Days of Cash



- ◆ At a 10% cost of capital, maintaining large cash positions costs these carriers a total of \$1.7 billion per year (vs. \$850m in 2000)
- ◆ As credit card processors react to credit crisis, carriers prepare for bigger cash holdbacks
 - Ex.: Frontier filed for bankruptcy after its credit card processor increased holdbacks

2. **Hedges:** Fuel hedges are not a panacea, and may not be fully exploited, partially due to their cash cost



Southwest Airlines

Southwest ended 2Q 2008 with \$5.8 billion in cash & short-term investments, which included \$4.4 billion from collateral deposits in fuel derivative instruments.

2Q 2008 Fuel Expense: \$894 million

2Q 2007 Fuel Expense: \$607 million

QTR	Percent Consumption	Average Price (bbl)
1Q	75%	\$51
2Q	70%	\$51
3Q	80%	\$61
4Q	80%	\$58

- ◆ Financial instruments such as fuel hedges are in use (possibly underused), but they have downside risk!
- ◆ Southwest has put almost 80% of its cash up as collateral deposits on fuel derivatives. They are betting that those derivatives will continue to have value. *However, what if fuel prices continue to fall?*
- ◆ United reported a third quarter net loss of \$779 million, of which \$519 million is from losses on fuel hedge contracts. The recent drop in fuel prices has driven down the book value of the hedges

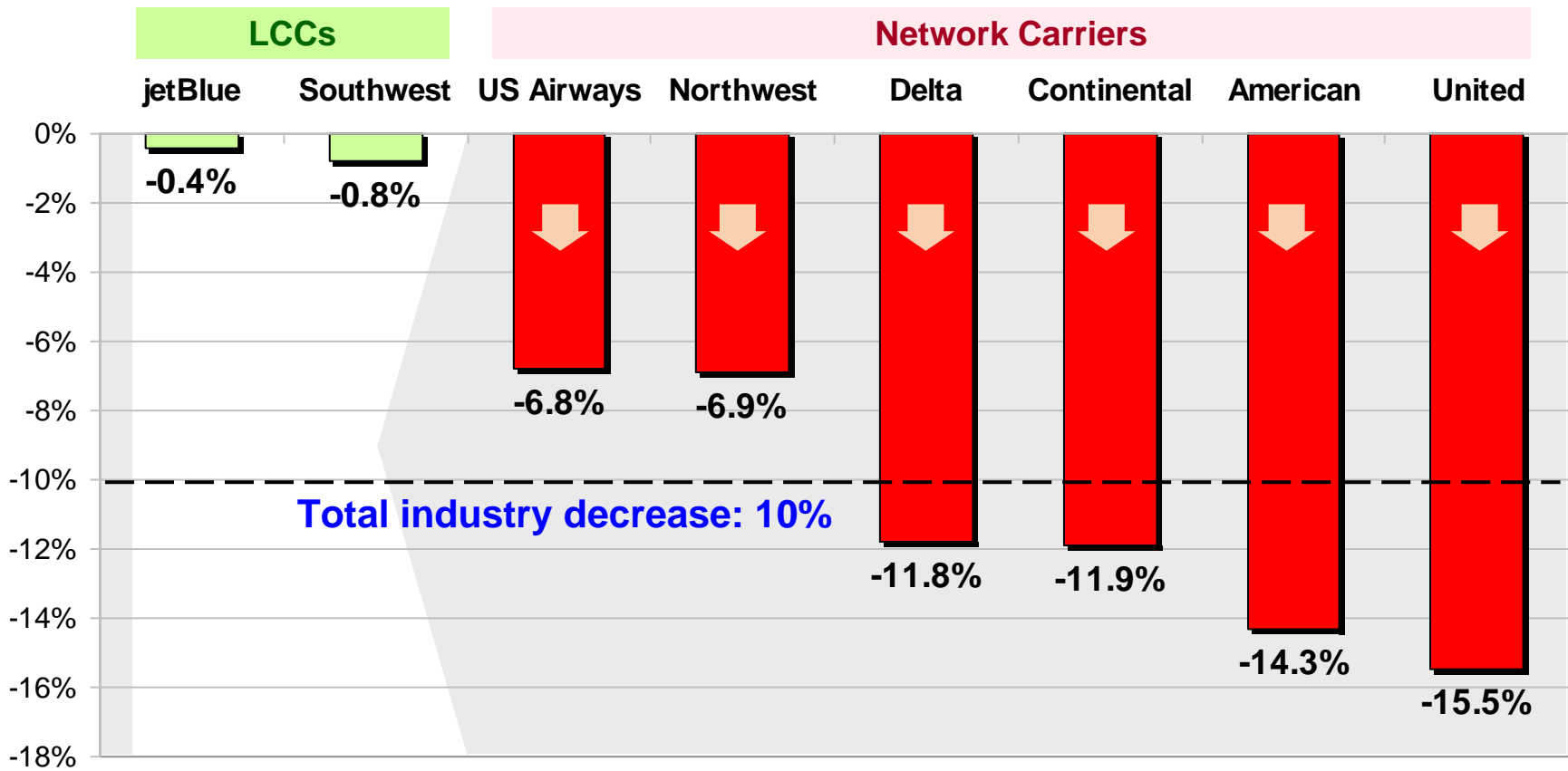
3. **Commercial Strategy:** Airlines are experimenting with many different ancillary revenue initiatives

	Ancillary revenue item	Airlines using	Revenue (\$ per pax)	Operational impact	Risk
<i>Previously free</i>	Change fees	All	Second Round?	Negligible (call center and check-in staff time)	Shift to carriers with less restrictive policies (LCCs)
	Fee for checked bags	Most	\$3 - \$4	Reduce checked bags Reduce PAWOB costs	Less overhead space Pushback in corp contracts
	Buy-on-board catering	Most	\$2 - \$4	Reduce catering costs Cut galleys (more seats) Lower maint. & weights	Resentful customers Cash handling Cleaning costs (same?)
<i>Product add-on</i>	Preferred seating	NW, UA, US	\$1 - \$2	Changes to res systems Problems in irregular ops	Dilution of FFP elite status Resentful customers
	Onboard internet	AA, DL	\$0.25 - \$0.50	Installation time Additional weight & maint.	Low (neighbor's porn?)
	Double/triple miles for fee	UA	\$1 - \$2	None	Dilution of FFP value
<i>Other</i>	Seat tray or boarding pass advertisements	Several	\$0.25 - \$0.50	Negligible	Brand dilution
	<i>Incremental RASM</i>		<i>0.75 cents</i>	<i>... against CASM increase of up to 2 cents</i>	

Surviving in this environment also requires capacity cuts... which have the effect of expanding LCC market share

Airline Domestic Seat Capacity Cuts

Change in seat departures, November 2007 vs. November 2008



Current capacity cuts expand the market share of LCCs, who are actively pursuing business customers

Airlines evaluate several inter-related factors to identify routes to cut

◆ Marginal Flying

- Identify least profitable routes
- Look for low strategic value, often disconnected from hub
- Long, “thin” routes — *Ex. BOS-SAN 5,400 gns = \$16,000 = \$90/seat = \$112/psgr each way!*

◆ Smaller Aircraft

- Cut smaller aircraft, with high unit costs, typically 50-seat RJs
- Implications for hub strategy

◆ Older Aircraft

- Cut older, less efficient aircraft and the associated flying
- Where possible cut whole fleet types and optimize by station — example: MD-80 retirements at Alaska, Midwest

Cuts are concentrated in smaller markets, typically with RJ service, as well as in non-hub routes

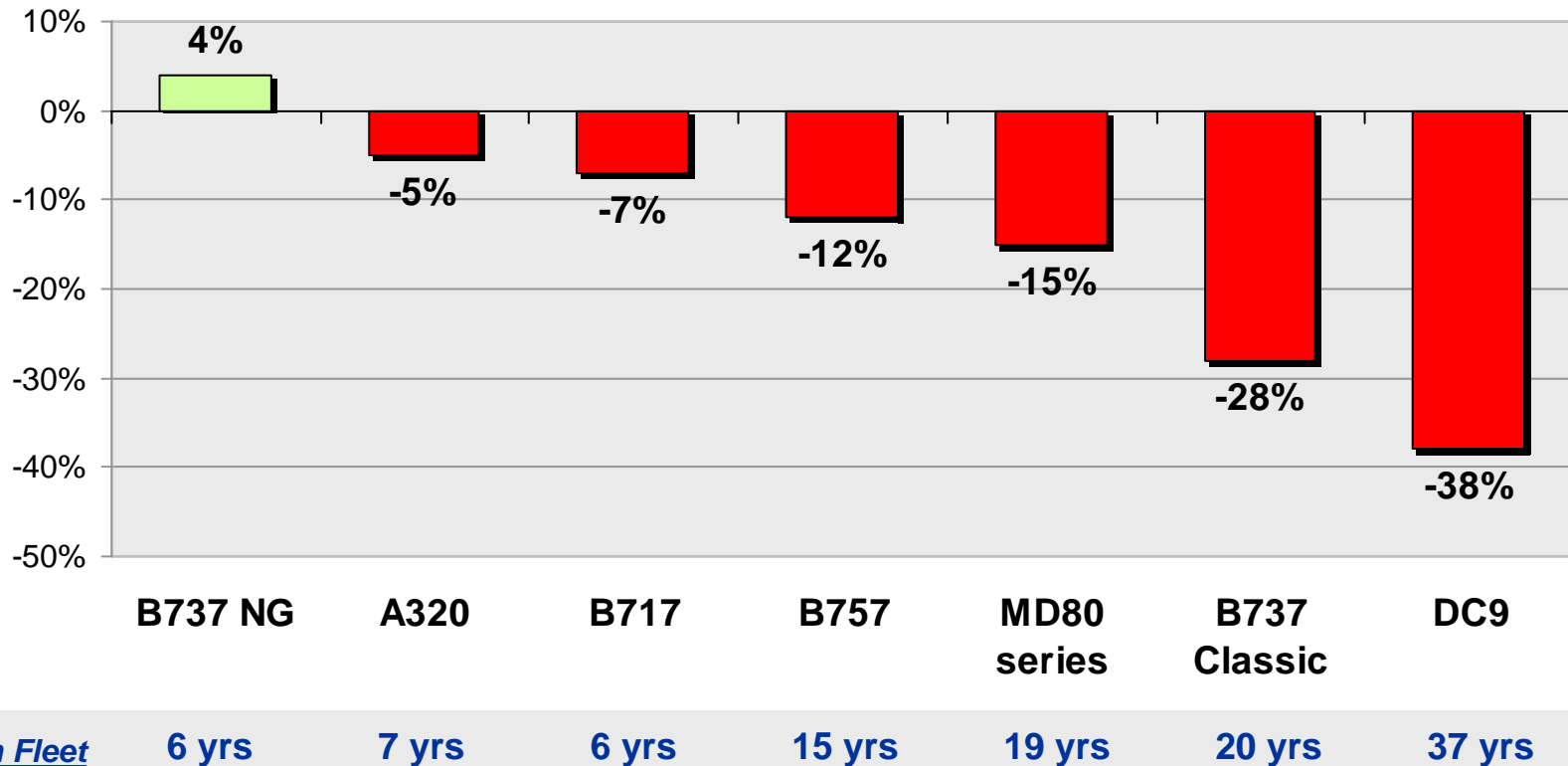
U.S. Carrier Route Cancellations/Reductions by Route Type

Excludes carriers flying only small propeller aircraft

	Small Market (<100 PDEW)	Long & Thin	Strong LCC Presence	Hub	Non-Hub	Primarily 50-Seat RJs
Total number of routes (Nov 2007)	2441	196	1671	3284	1197	1028
Cancelled by Nov 2008	505	35	255	346	368	212
Share Cancelled	21%	18%	15%	11%	31%	21%
Frequency or capacity cut by 50% or more	103	6	49	111	66	20
Share Reduced	4%	3%	3%	3%	6%	2%

4. Fleet Efficiency: Schedule reductions have focused on older generation narrowbodies

Change in Scheduled Departures by Aircraft Type
November 2008 vs November 2007



Major airlines have parked nearly 60% of their less efficient aircraft...

Alaska	Eliminated 9 MD-80s this summer
American	Retiring 30 MD-80s and all 34 A300s by end of 2009; eliminating 38 ERJ-135s (37 seats) and 26 Saab turboprops from American Eagle fleet
Continental	Retiring 67 737-300s and 737-500s
Delta	Reducing RJ fleet by up to 70 aircraft over the next year
Midwest	Eliminating all of its 12 MD-80s this fall
Northwest	Retiring 24 DC-9s
Southwest	Retiring 16 737-300s and 737-500s
United	Removing 94 737-300s and 737-500s, 6 747-400s
US Airways	Eliminating 6 737-400s and 4 A320s

Exited fleet

*Scope clause
arbitrage over*

Mesa!

Exited fleet

The original RJs

End of the classics

Note: Estimated 436 of less efficient aircraft represent a total of 730 of these types in U.S. fleets in May 2008

Source: ACAS, Industry News Sources, SH&E Analysis

Airlines have also implemented operational strategies to reduce demand for fuel, though these impose higher capital costs

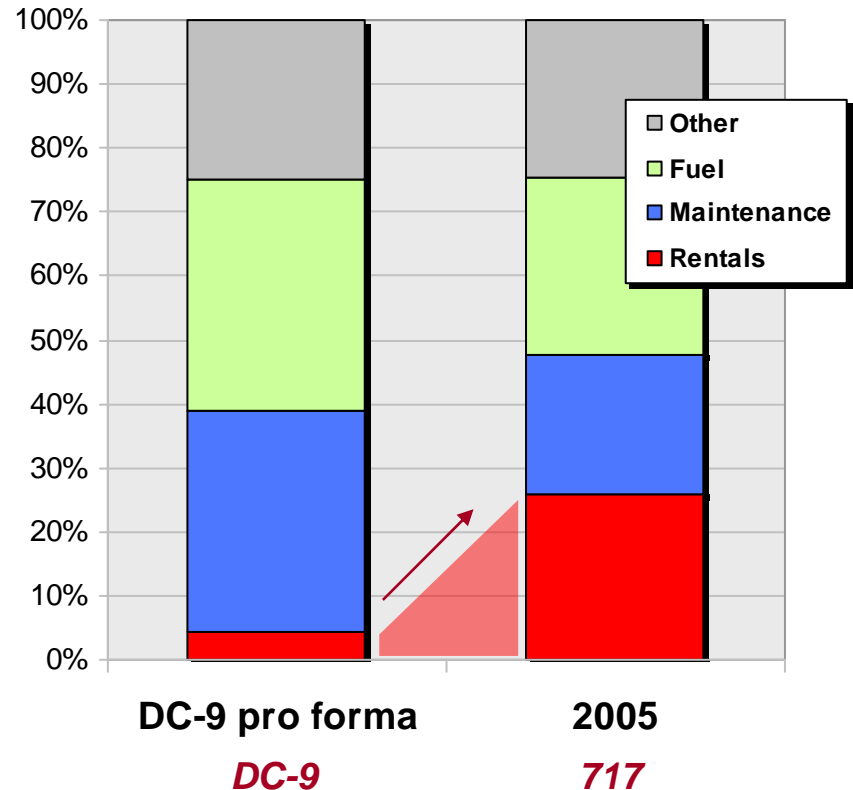
- ◆ **Winglets: 3-5% reduction in fuel burn**
 - American, Delta and Continental have observed 3-4% lower fuel consumption on their 757s with winglets
- ◆ **Engine washing: 1% reduction in fuel burn**
 - Pratt & Whitney estimates 0.5% to 1.5% lower fuel consumption when engines are washed twice per year
- ◆ **Other strategies have smaller payoffs that come with their own costs and risks**
 - Single engine taxi: 0.3% reduction in fuel consumption per trip...
...but risk of engine failure on startup
 - Optimized routing, tighter fuel planning: 0.2%...
...but concern about safety and labor relations
 - Turning off APU on ground: <0.1%, lighter interior fittings and carts: <0.1%

Greater fuel efficiency shifts airlines' production function to higher capital costs...

- ◆ **More fuel-efficient aircraft have higher capital costs, lower maintenance and fuel costs**
 - At 2005 input prices, Hawaiian's Direct Operating Costs are 6% higher for the DC-9 than the 717
 - Cash ownership costs, however, are over five times their 1995 level with the 717
- ◆ **Higher capital commitments reduce an airline's flexibility to respond to short-term dislocations**
 - In 1995, Hawaiian could reduce the cash outlays related to its interisland fleet by a maximum of 95% by grounding the fleet
 - In 2005, it could reduce cash outlays by just 75%

Hawaiian Airlines DOC Realignment
Interisland Fleet, 1995-2005

Share of Cash DOCs

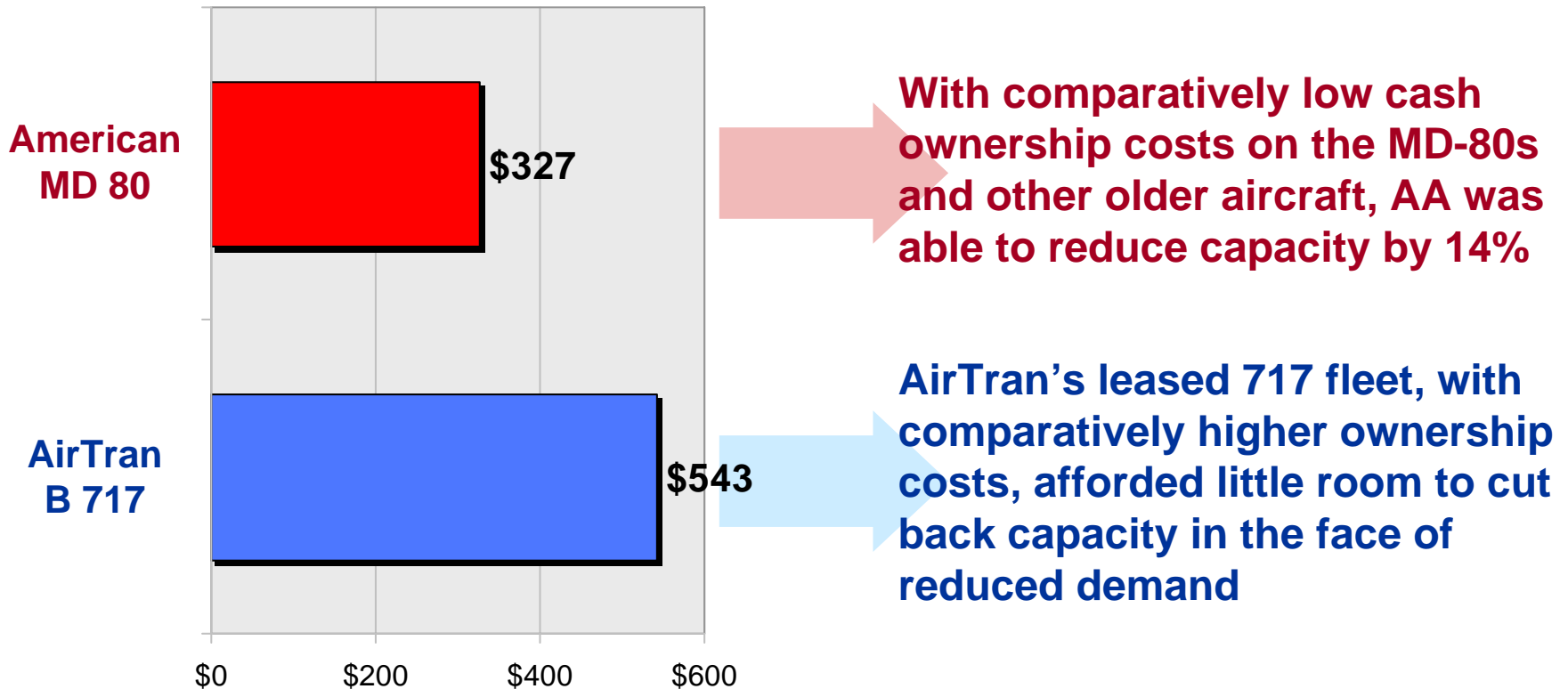


Notes: DC-9 2005 pro-forma figures are calculated as: (DC-9 fuel burn at 2005 fuel prices)+(cash maintenance costs inflated at 7% per year from 1995 levels)+(717 pilot labor costs)+(DC-9 1995 ownership costs)

Source: Form 41, Hawaiian Airlines 1995 10-K. Cash DOCs include pilot labor, fuel, insurance, aircraft rentals, and maintenance (excluding maintenance burden).

...Yet higher cash costs for aircraft ownership reduce an airline's flexibility in the face of declining demand or higher fuel prices

Aircraft Ownership Expense per Block Hour
for YE 2Q 08^{/1}



^{/1}. Ownership costs shown as rentals, principal and interest payments; depreciation is not included.
Source: US DOT Form 41 via Database Products

Using a combination of operational and financial levers to manage volatility affords downside protection and upside benefits

