



J. Michael Stepp
Manager, Business Consulting
September 28, 2004

Due Diligence 360° Workshop

Control the Investment Process

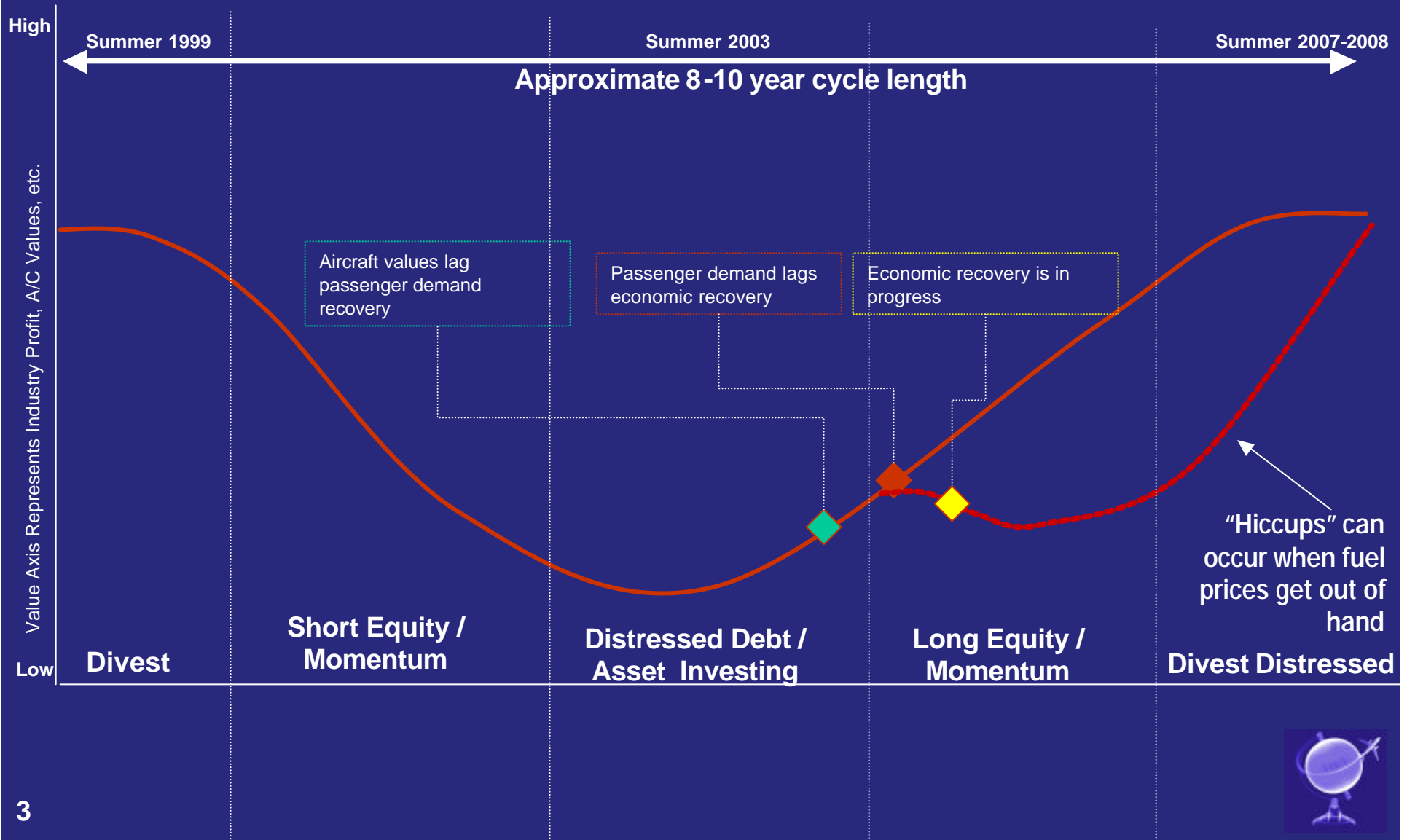
2004
Fall

Prerequisites for Airline Investment

- 1) Appetite for Risk
- 2) Strong grasp of internal and external variables driving performance



The economic cycle presents a unique investor opportunity to target investment types.



- **Fundamentals of Airline Investing: Deciphering the Business Model**



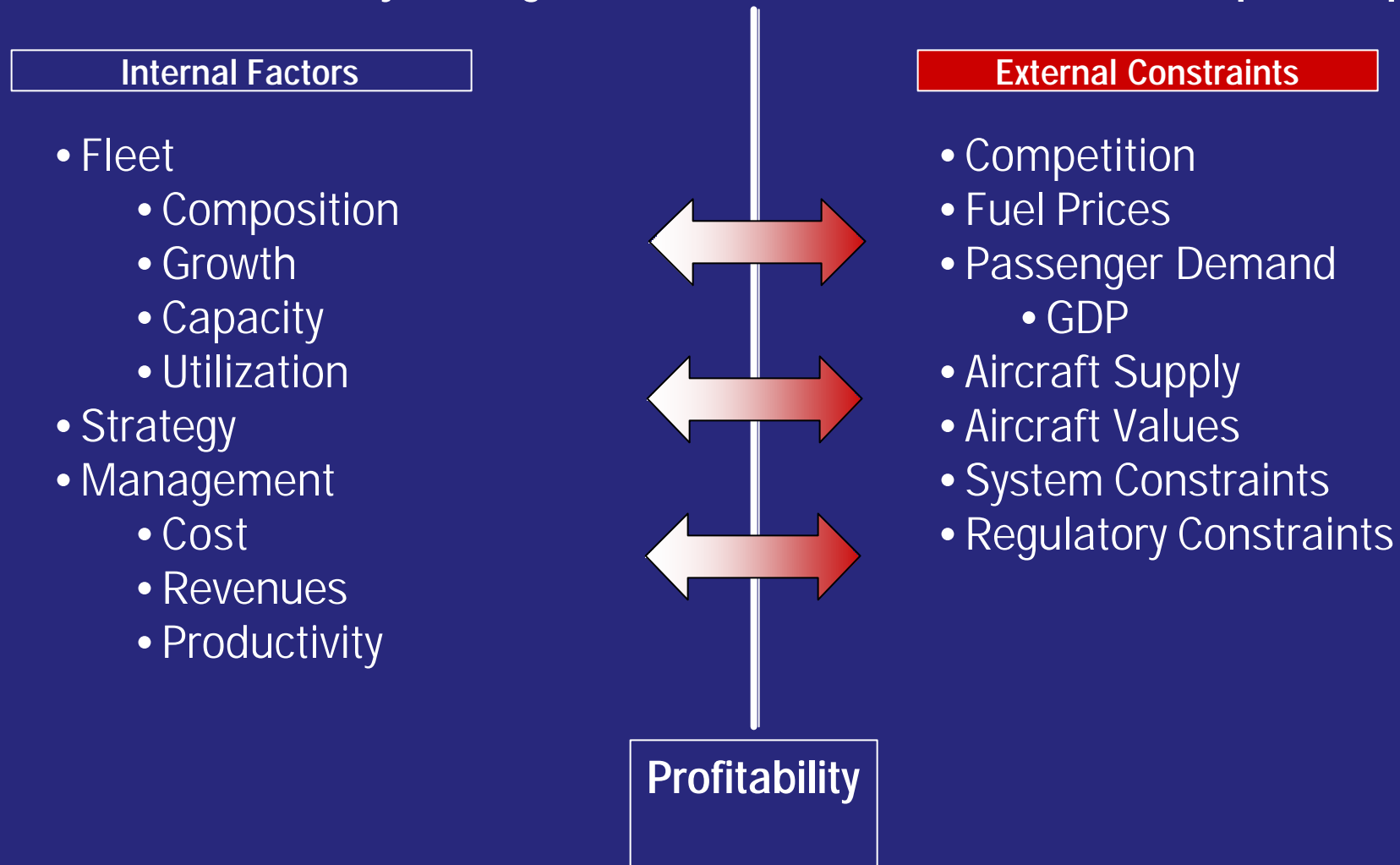
- Analyzing Airline Strategies

- Are Low Cost Carriers a Better Investment? A Tale of Two Models...

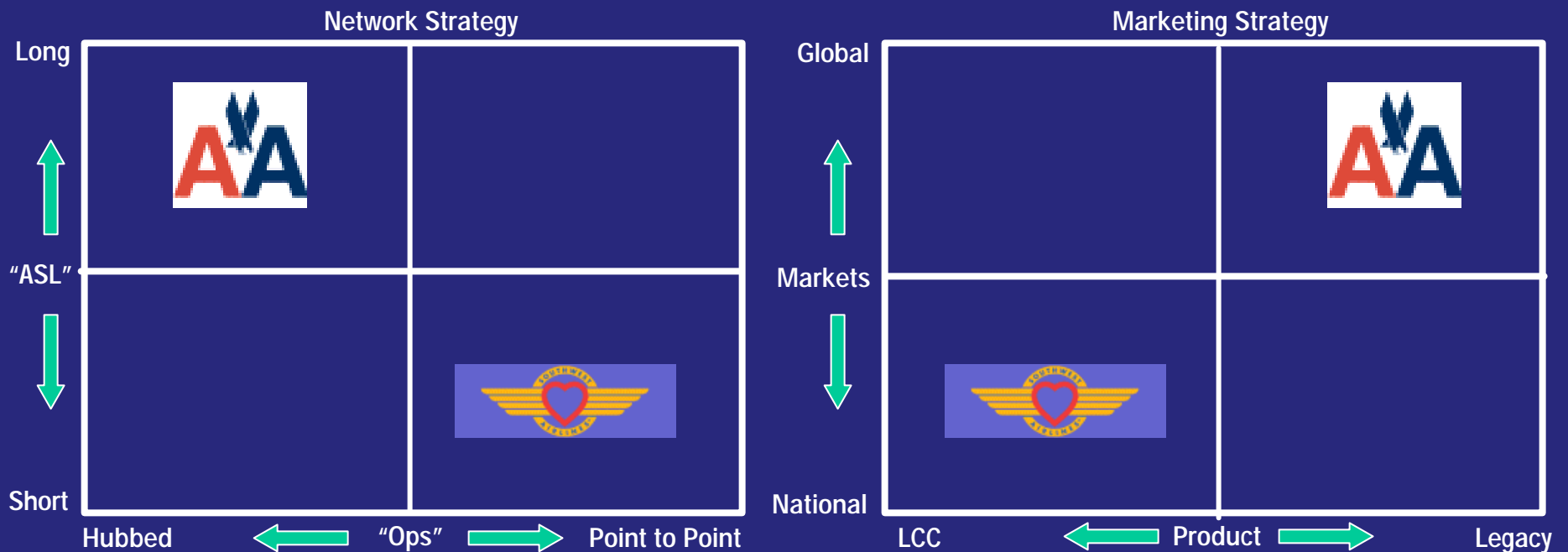


Disaggregating the Business Model

Most analysts concur that the fleet is the basis of airline analysis, and strategy, as articulated by management, is the core of an airlines competitive position



Fleet and strategy must be reasonably aligned



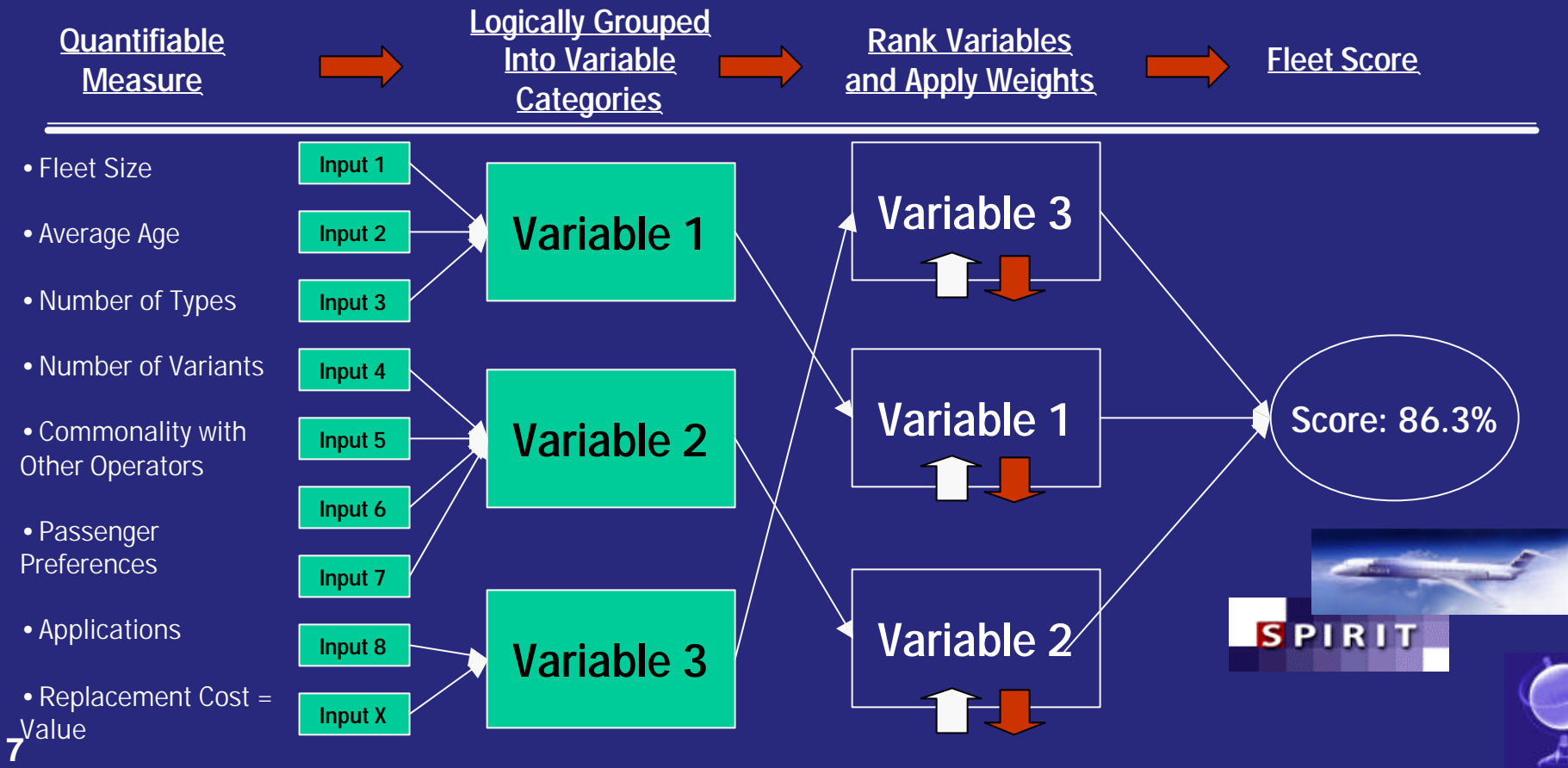
American's Fleet



Southwest's Fleet



Fleet "quality" is a multidimensional characteristic. Rating quality relies on a number of subordinate variables. These must be carefully selected and appropriately weighted for each airline so that the final calculus is accurate..

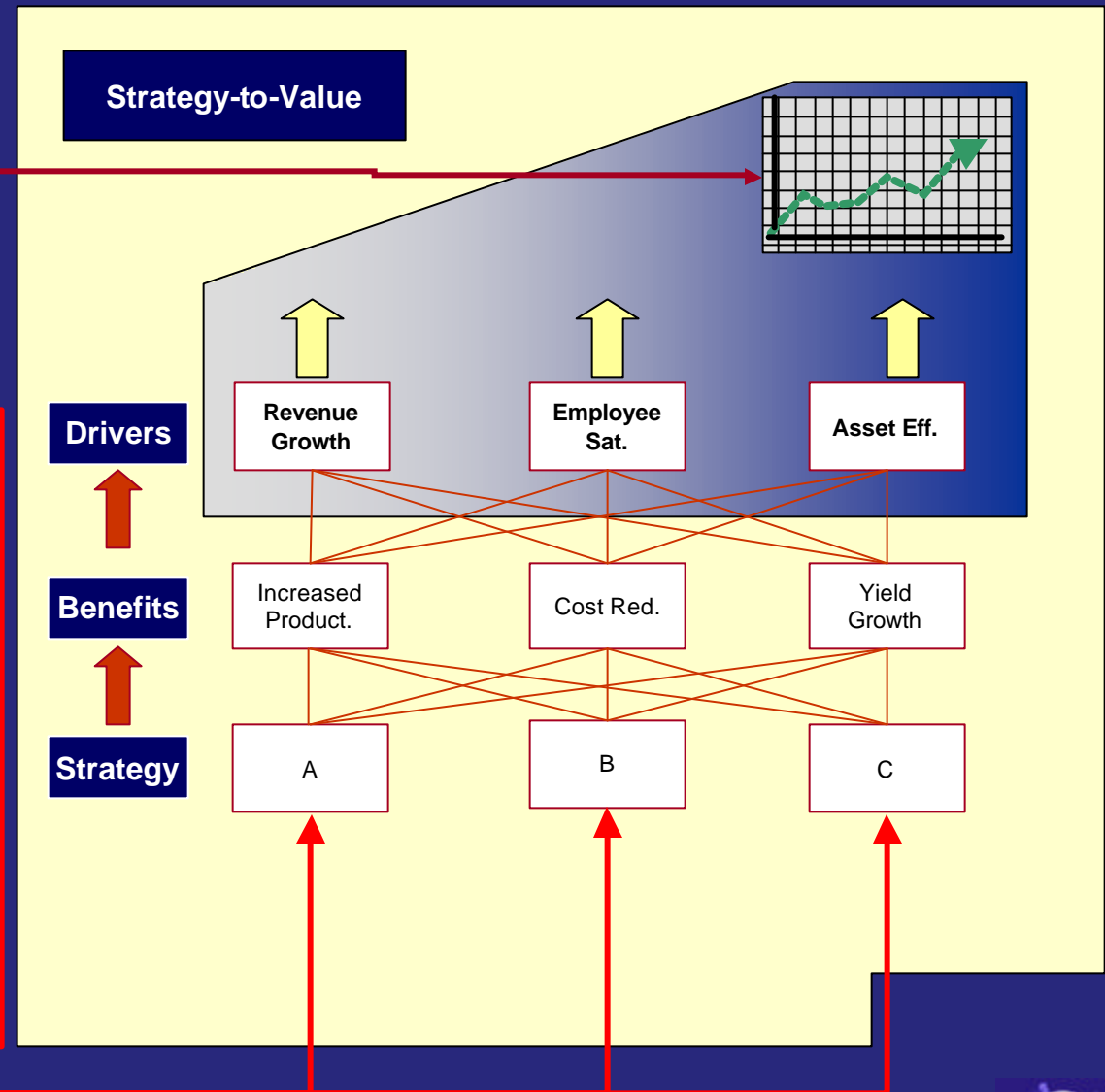


Linking Strategy to Shareholder Value

Strategic initiatives yield benefits which in turn set the stage for value growth. Growth is not guaranteed, but historically there has been a **strong positive correlation** between drivers like profitability growth and actual return on equity.

Strategic Initiatives

- Fleet Rationalization
- Fuel Hedging
- Network Expansion / Contraction
- Marketing Programs
- Distribution Channel Optimization
- Outsourcing
- Alliances
- Inventory Management
- Others...



The Strategy is Instrumental in Driving Airline Profitability, and Value and Profitability are Highly Correlated

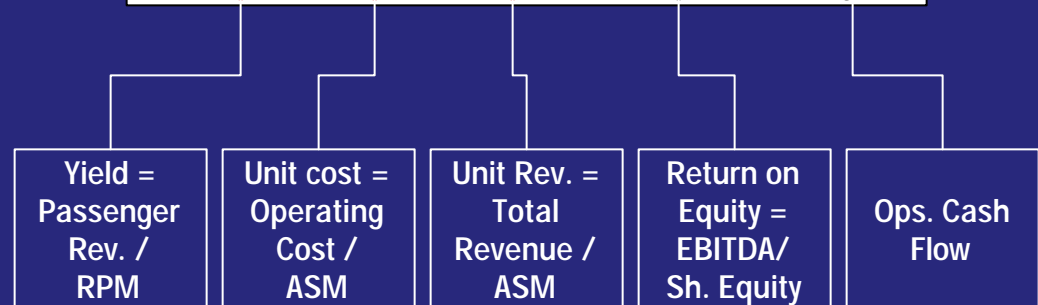
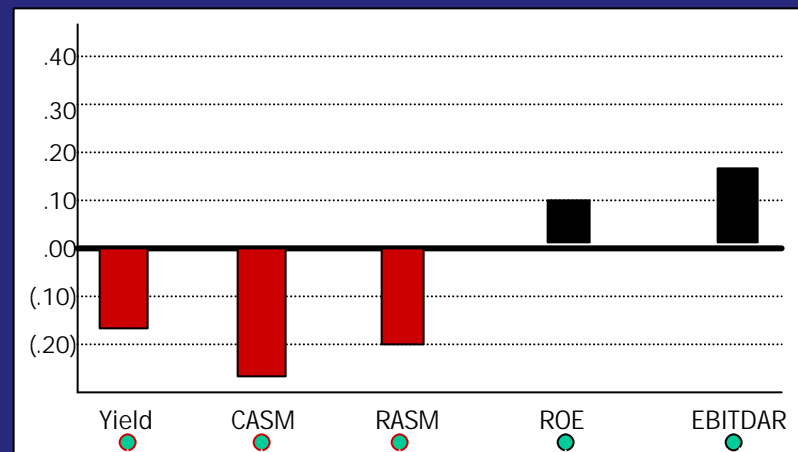
Revenue Drivers

- Passenger Revenue
- Cargo Revenue
- Ancillary Revenue

Cost Drivers

- Labor Costs
- Fuel Costs
- Maintenance Costs
- Ownership Costs
- Advertising, Sales, Marketing
- Route/Navigation
- Airport Costs
- Other

Key Profitability and Return Metrics



- Fundamentals of Airline Investing: Deciphering the Business Model

- Analyzing Airline Strategies



- Are Low Cost Carriers a Better Investment? A Tale of Two Models...



Benchmarking provides insight into competitor performance, but also produces “best-in-class” performance targets.

Company Research: Competitors and Global “Best-in-Class”

Identify

~10% of Effort

Understand

~80% of Effort

Adapt

~10% of Effort

1

Identify who to benchmark

2

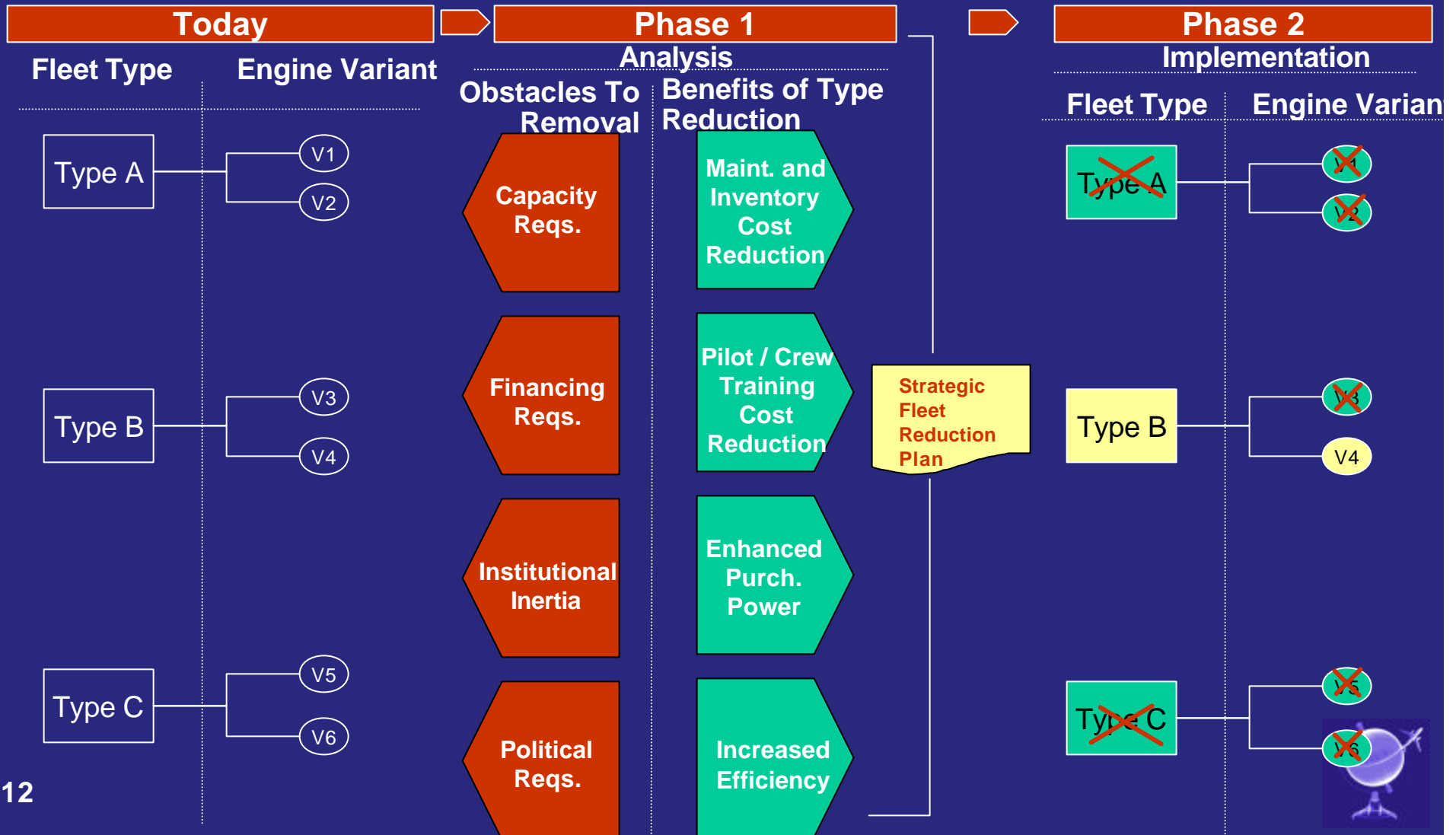
Collect data (public and private as available). Align Timeframes

3

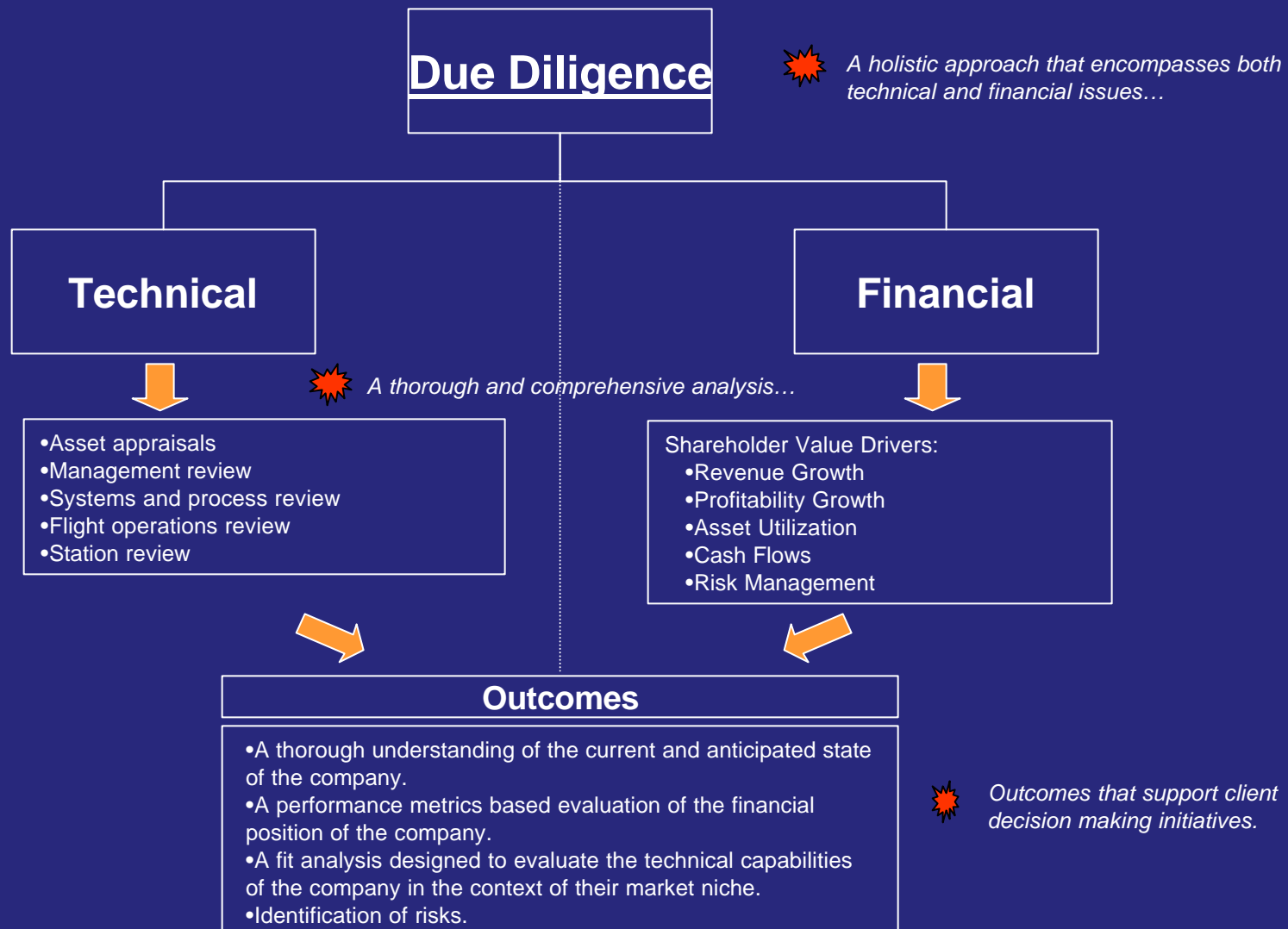
Analyze data in relevant buckets , amend for accounting discrepancies.



Fleets must be optimized for strategy, and fewer types and variants is always preferable.



Due Diligence Roadmap



- Fundamentals of Airline Investing: Deciphering the Business Model
- Analyzing Airline Strategies

• Are Low Cost Carriers a Better Investment? A Tale of Two Models...



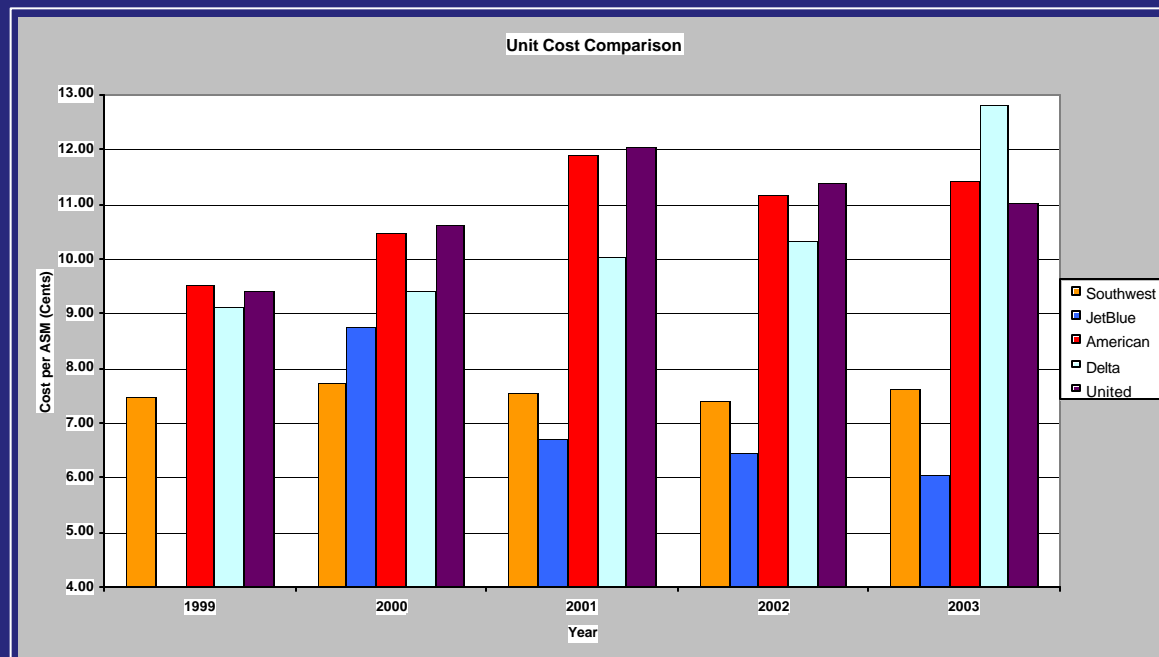
LCC's are the Future of the Industry

As business travelers become more price sensitive, network carriers will be required to manage towards lower yields. In essence they too must become LCC's.

Yield Convergence – Market Domination

- Downward pricing pressure already having a noticeable effect on yields industry wide.
- Low cost carriers have a substantial unit cost advantage over the majors.
- Low cost carrier dominance is reflected in their relatively large market capitalization. The market rewards low cost operations.

The Low Cost Advantage



Low Cost Carriers a Good Investment? A Tale of Two Models

As low cost carriers proliferate, investors must be wary of strategic differences.

It was the best of times,...



Credit Rating: **A**

Market Cap: **\$11.49 Billion**

Cash Balance : **\$1,768 Million (June 2004)**

August Load Factor: **75.1%**

Fleet Size: **378**

Fleet Types: **Boeing 737 – 200, -300, -500, -700**

Network: **Point to Point**

...it was the worst of times,



Credit Rating: **B-**

Market Cap: **\$180.9 Million**

Cash Balance: **\$450 Million (June 2004)**

August Load Factor: **45.5%**

Fleet Size: **61**

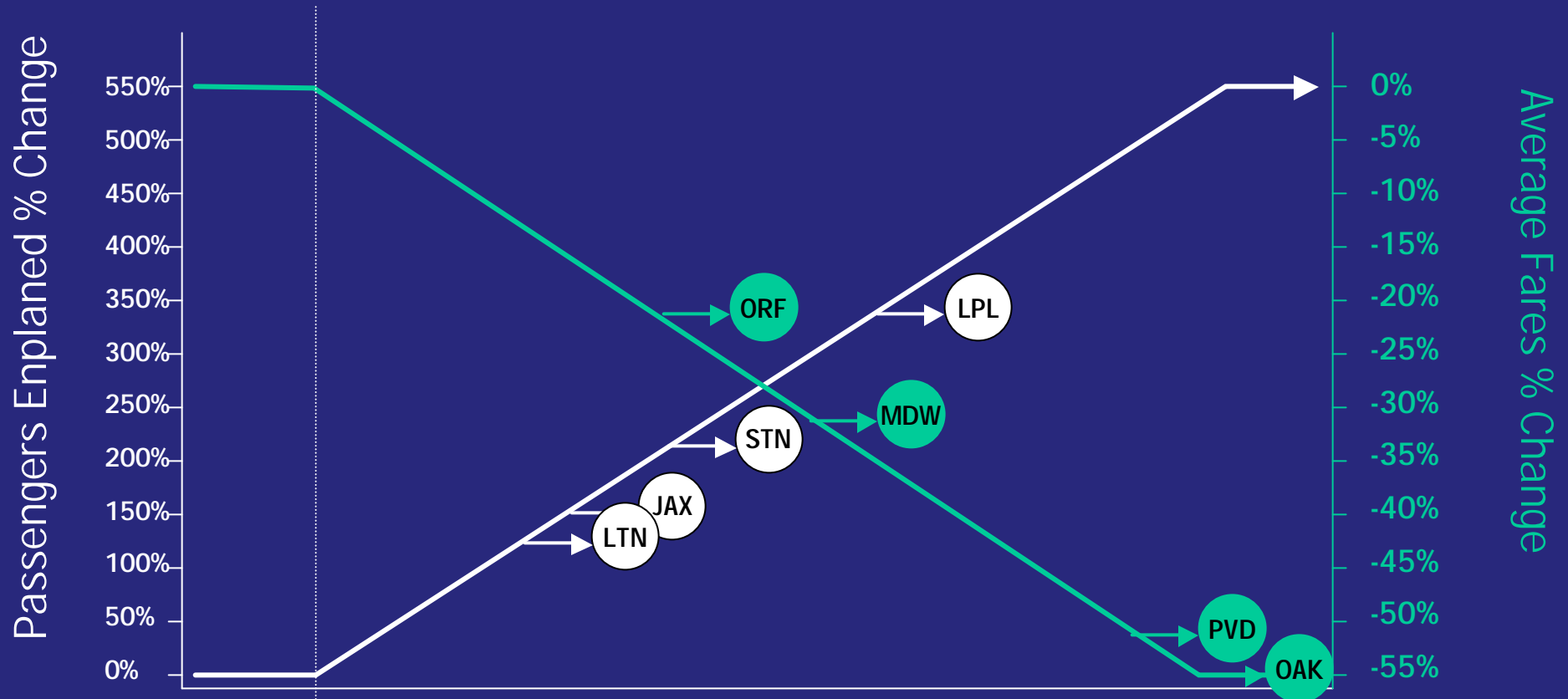
Fleet Types: **CRJ –200 ER, A319-100 (Coming Q4 04)**

Network: **Hubbed (Washington IAD)**



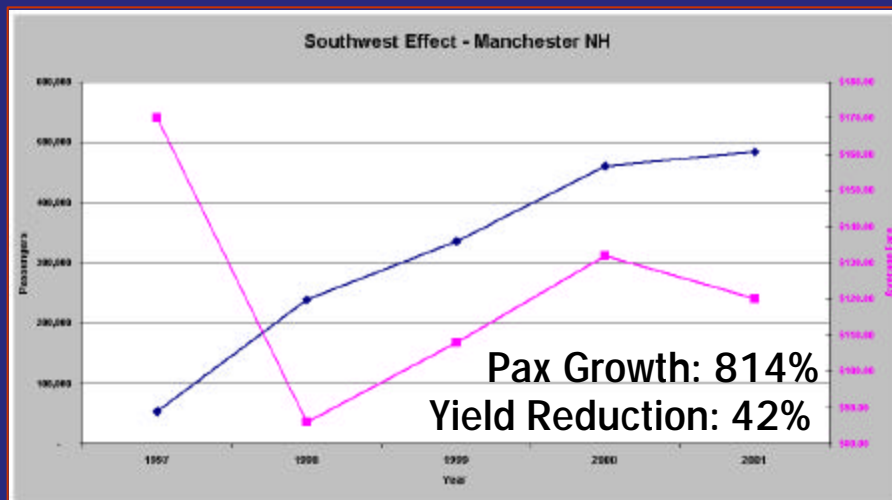
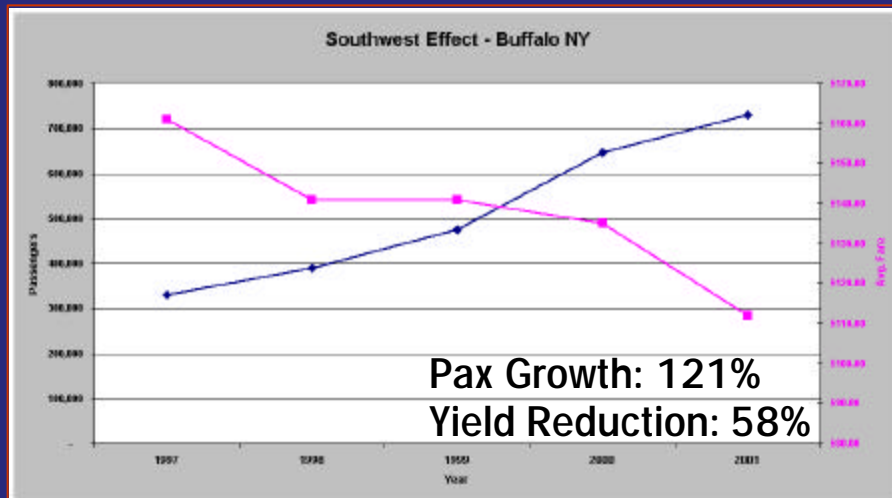
For Independence, Why A Winter of Despair?

When LCC's enter the market two things happen, first average fares go down, then demand increases. This phenomenon has been labeled "The Southwest Effect" but it is equally true in Independence's markets.



Mutually Assured Destruction? The Airline Industry Arms Race

Low cost carrier market entry dramatically impacts carrier yield. Here are 2 examples from the US...

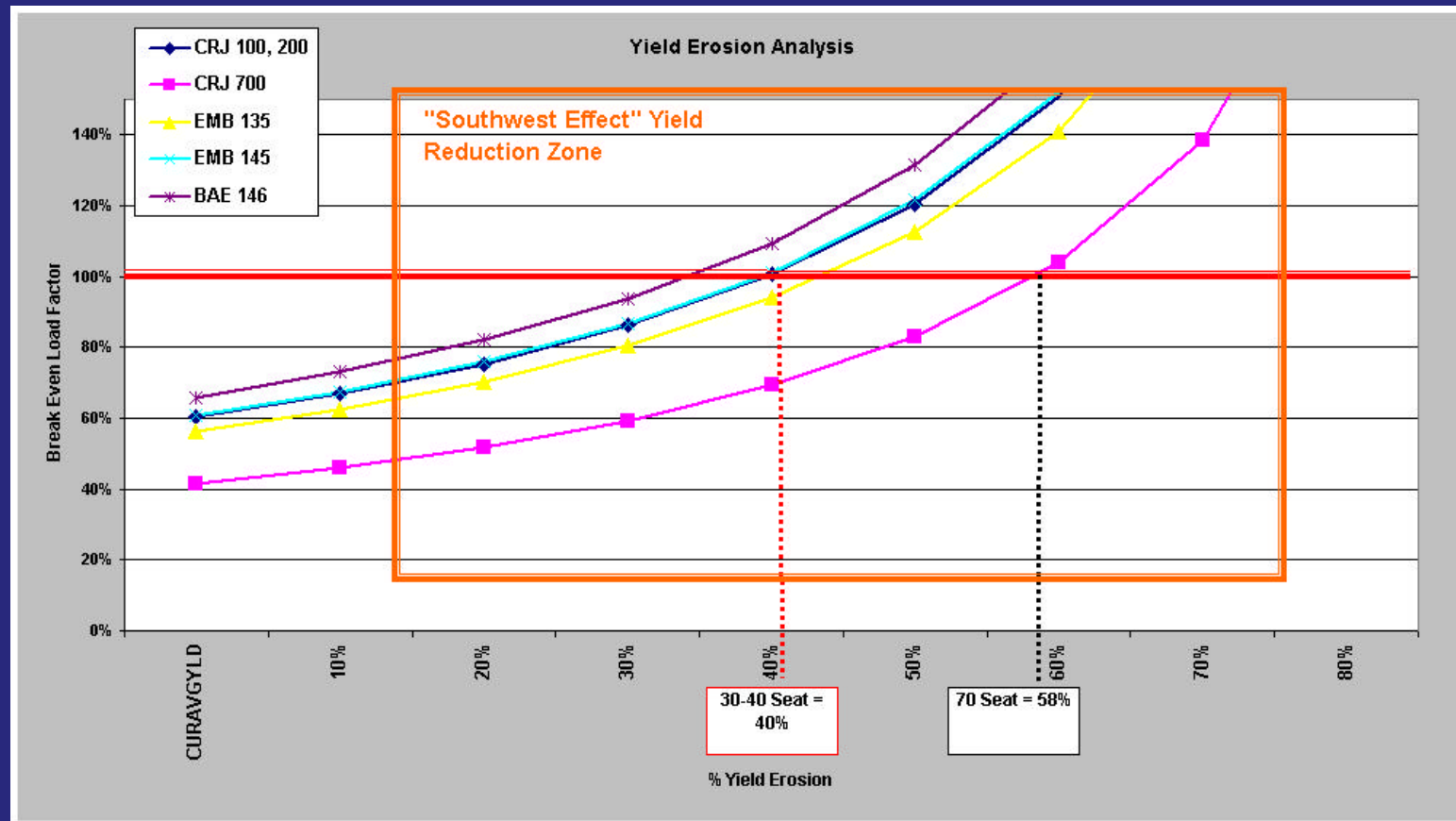


- LCC enters market (in these cases Southwest)
 - Low fares drive yields down
 - More passengers travel
 - Majors respond by lowering fares
 - Yields drop even lower
 - Majors must align costs to survive
-
- Same in PHL and WAS with entry of Southwest and Independence



The Threat to Low Cost RJ Operations

If yield is universally impacted by LCC entry, many RJ operations may become unprofitable. **High CASM = Highly susceptible to yield erosion.**



1) CURAVGYLD = Assumed Average RJ Market Yield (\$.24) (MBA Aircraft Database)

2) Break Even Load Factor = Cost Per ASM / Yield

3) Yield Erosion = CURAVGYLD * % Reduction (As indicated along X Axis)

4) If Break Even Load Factor > 100%, IMPOSSIBLE TO SUSTAIN PROFITABLE OPERATIONS



www.mba.aero

