U.S. AIRLINE INDUSTRY OVERVIEW

Hans J. Plickert
The Transportation Group (Capital Limited)

Current Airline Financial Strength

A review of the airline industry's financial reports reveals a generally good picture. In fact, in 30 years of following airlines, I do not recall a healthier industry than the current one. Since the public is also served well by and large, we must consider deregulation a success so far.

Of course, this new prosperity is not necessarily true of all companies in the industry universe. In fact, there are wide discrepancies between the very healthy and the marginal. For instance, at one end of the spectrum, about 76 percent of Delta's capital at the end of 1988 was represented by equity. The carrier boasted a 15.6 percent return on average equity and a 4.7 percent net return on revenues. At the other end was Eastern with a $377.6 million negative equity and a $380.9 million loss.

On balance, though, the industry is doing quite well at the moment, certainly by past standards. In the first half of this year, the U.S. majors experienced a return on sales of 0.94 percent which was down from last year's 1.24 percent entirely because of Eastern's and Pan Am's calamities. If one excludes those two carriers, the majors' first half return on sales was 3.68 percent materially better than the 2.62 percent return in the comparable 1988 period, a pretty good return by most standards. Finally, airline stocks have become the hottest stock market play. Of all the indicators, this is probably the least relevant, but as a long-term observer of the industry, who wrote a relatively controversial article some 15 years ago, called "The Financial Strength of Airlines", I am glad to see some converts to my earlier views.

There appear to be two principal reasons for this strong performance. First, despite the absence of domestic traffic growth for more than a year now, revenues have in fact risen significantly because of a steady and strong gain in yield. In 1988, 50-state yields rose 7.6 percent from the year-earlier base. The increase was the result of an 11.1 percent increase in full fares and a 7.2 percent gain in discounts yields. So far in 1989, over-all yields are up another 10.4 percent, despite individual components that have risen less. The principal reason for the double digit gain is a relatively small but significant shift in the traffic component represented by discount fares from 91.1 percent last year to 88.9 percent in the first seven months of 1989. Because of this, passenger revenue growth for the major U.S. carriers was 9.1 percent in the first half despite total system traffic growth of but 0.1 percent.

Secondly, load factors have remained remarkably steady despite the disappearing traffic growth. In fact, this is one area where results have been quite surprising. In my experience as an investment analyst, the question of year-ahead overcapacity, was a standard topic at year-end. In fact, airlines appear to be able to control their capacity more effectively today than they were able to in the past. I am not sure I know all the reasons for that but only note this as a fact. In any case, despite consensus estimates of capacity gains of at least 6-7 percent annually, domestic seat-miles of the majors actually rose only 5.3 percent in 1987 and 1.5 percent last year, closely in line with traffic experiences, not to mention a 3.5 percent decline in the first 7 months of this year. The average domestic load factor for the U.S. majors was 61.9 percent in 1987 and 61.6 percent last year and has been holding in that area so far in 1989. Load factor management appears to be working well, with excellent results for bottom-line performance.

I should note at this point that it is difficult to fully analyze the first half 1989 statistics since we cannot be sure of the impact of Eastern's strike on the industry's and individual competitors' performance. Parenthetically. I will note that while most analysts have been crediting Delta with most of the strike benefits, American has probably benefitted materially as well. The timing of its Caribbean buildup and the Raleigh/Durham hub development could not have been better. And while I am hedging on the accuracy of this year's statistics, let me also point out that statistics for the majors will change again next year, when America West and Southwest Airlines will join the club.

The Immediate Future

There are some signs, though, that the immediate future will become less rosy. First domestic traffic growth for the majors continues to be unimpressive. It was up 1.0 percent last year, but for the first seven months of this year it was down 2.5 percent. Again, I should call attention to the Eastern caveat, for surely some trips have been cancelled rather than diverted to other airlines. Total system traffic and revenue growth have been helped along by surging international tourism. International passenger miles of

the U.S. majors were up 17.8 percent last year but only 10.0 percent in the first seven months of this year. Indeed, there appears to be deceleration here as well. The July gain was only 5.1 percent.

What makes the sluggish traffic performance worrisome is a significant slowdown in yield gains. As I said before, domestic yields were up 10.4 percent through July on a year-to-date basis. The monthly gains decelerated sharply to 3.2 percent and 1.1 percent in June or July, respectively, though. This has obvious adverse implications for revenue growth of the domestic airline industry. It should also be noted that the decline in yield performance is not solely the result of promotional campaigns, such as Kids Fly Free. Full fares were up only 0.6 percent in both June and July.

Because of these trends, we are expecting a general downtrend in earnings to develop this fall. This may not be true of the over-all industry statistics because at some point both Eastern and Pan Am should start improving their numbers--hope does spring eternal--but it does appear to us that the very good times may be over for the time being. We are not expecting a severe setback in profitability at this point, but it certainly will be interesting to see how all the fabled management disciplines of revenue management will hold up in a period of down earnings.

Basic Concerns and Challenges

While we should certainly enjoy the industry's current prosperity, we should not be blinded to the fact that there are some strains that have been developing for some time now.

One of the most significant consequences of deregulation has been an enormous stimulation of traffic growth. In 1978, the U.S. certificated airlines enplaned about 275 million passengers. Last year, the Form 41 carriers enplaned about 455 million passengers, an increase of about 180 million. Now Boeing forecast another 190 million gain in U.S. passengers between 1988 and 1995 and essentially a doubling of world-wide passenger miles between 1988 and the year 2000.

Managing Growth. It is the management of that growth that represents the major challenge for the airline industry as well for the various governmental bodies involved in transportation. Despite some upheavals and disruptions, we have been fortunate so far. A considerable part of the growth that has taken place since 1978 was absorbed by an increase in average load factors. In the 1973-77 period, U.S. industry load factors averaged about 55 percent. In the past two years, they were about 63 percent on average. Moreover, at least for a while, total scheduled departures in this country decreased. They were down about 10 percent between 1979 and 1983, partly because of the fuel crisis and partly because of the ATC strike in 1981. Equally important, the average per-plane seating capacity of the major airlines increased 11 percent during that period.

I believe that the industry as well as the regulatory authorities were misled into complacency by those trends in the earlier years of the decade. I remember one airline's presentation of new hub projects in 1985. At the time I asked how the ATC system could possibly absorb all the additional flights contemplated and was assured that was no problem. Well, since 1983, scheduled departures in this country have risen around 40 percent and the system is creaking.

Airport and Airway Constraints. You may remember that most airlines made relatively minor changes in their scheduled block times in 1987 to enhance their on-time performance. This usually involved only a few minutes' addition, but a few minutes per flight add up. Incidentally, they add up for the traveler also. For instance, the average scheduled speed of one particular flight from LaGuardia to O'Hare, leaving at 6 PM, is a resounding 281 miles per hour. In the case of American Airlines alone, these minutes totalled 180 hours per day of additional flying, equivalent to taking 15.5 aircraft out of the fleet. At the time, I made an estimate that the additional operating costs for the U.S. carriers could be more than $1 billion per year. Since then, I have seen estimates that place the total operating cost of ATC delays at $2 billion-plus. I should also note that trips not taken because of inconvenience represent a cost. For instance, if passenger revenue were reduced only 1 percent because of a reluctance to travel, the loss to the major airlines would be $500 million. This may not appear to be a very large figure but it should be seen in the context of our estimate of an $860 million net income for the U.S. majors this year.

Nor is the increasing crowding of the airspace and airport facilities a localized U.S. phenomenon. In fact, only a few days ago a European study group released a report which calculated the cost of ATC delays in Europe at about $790 million last year, and the total economic cost of air and ground delays at about $5 billion.

In this country, we have been carrying on a debate about the future structure of the Federal Aviation Administration for some time. Perhaps it is time to

focus on action. Equally important, modernization of the airways system cannot be further delayed. The lead times are just too long. Even now, the National Airspace System contemplates installation of some critical system as far into the future as 1995.

Load Factors. In its forecasts, Boeing projects that the increase in travel volume between 1988 and 2005 will be handled by an increase in load factors from 66.0 percent to 67.0 percent, a 12.8 percent increase in utilization, and a significant gain in seating capacity from 186 seats per aircraft to 237. Incidentally, this latter projection is highly significant because there has been virtually no change in average seating capacity per aircraft since the early years of this decade. Again, I suspect the continuing efficiency of older jets at the fuel prices that prevailed in the past few years, coupled with the requirements of hub and spoke system, has simply obscured the growing need to enhance seating capacity over time. The current rush to buy Boeing 757s and similar aircraft is really nothing but a catch-up.

Finally, and very importantly, Boeing also projects an increase in the number of aircraft units from 7,200 to 11,800. In view of the fact that further frequency expansion is already impossible at several airports both here and abroad, one wonders how this increase in departures will be accomplished.

Capital Requirements. Let me turn to an issue which is closer to my competence, and that is the enormous financing needs of the industry in the next decade or so. Boeing's forecasts are for worldwide aircraft purchases of $516 billion between this year and 2005. About $225 billion of this will be delivered to U.S. carriers. At the moment, financing does not appear to be a problem for most airlines. Financial institutions have become fascinated by residual values of aircraft in an environment that has so far been characterized by an industry-wide appetite for used aircraft. But what will happen when the package freight companies stop building their fleet at the present rate or when a combination of economic conditions and phase-in of Stage III regulations lead to a much greater supply of older aircraft than the current experience suggests? My good friend Ed Greenslet suggests that, under some conditions, as many as 1,000 older aircraft could be looking for a home in the next three years. That could lead to some indigestion in the market.

Ownership Issues

That thought leads me to a few comments on some issues of ownership. We appear to be in another adjustment process to deregulation, one that increasingly involves the separation of ownership of the assets from their operator. The leasing companies account for a rapidly rising portion of aircraft orders. Similarly, virtually all of the year's U.S. aircraft deliveries are being financed by lease arrangements rather than purchase, partly for tax reasons. There appears to be some misconception, however. At least the popular press (and, I am afraid, the trade press as well) often confuses short-term leases entered into for tactical reasons with the kind of 20 to 25 year leases for modern jet equipment typically entered into by the large airlines. There is nothing wrong with this, but it does not enhance fleet flexibility. Indeed, it ultimately reduces it.

Nor is leverage as such undesirable. Some bills in Congress that would restrict takeovers based on certain leverage criteria miss the point. Judged by the proposed standards, a large number of airlines should be found unfit. Leverage is a normal part of the airline business. What is important is that monetization of assets does not proceed to a point where the provision of basic transportation needs is threatened in case of economic reversals. How this can be accomplished legally I do not know. But, ultimately, I think, we all have a moral responsibility to the system to make sure it survives.

There are two more ownership issues that we have to come to grips with some day. First, there is the question whether public facilities, rights of access, and international route authority, once granted by the federal government or other public authority, is private property that can be bought and sold without compensation to the public. I know there is considerable precedent now for the sale of slots and route rights. I would suggest, though, that the issue will become increasingly important as more and more airports have to limit access to additional flights.

Secondly, we will have to address the issue of the increasing internationalization of the airline industry. Already we have seen several foreign carriers invest in U.S. airlines. KLM's equity participation in Northwest Airlines, Ansetts's in America West, SAS in Texas Air, and now perhaps British Airways' participation in United all come to mind. Surely, for national defense purposes we have to be certain there is no foreign interference with our needs. Yet I am not sure we can use that argument without modification forever into the future. The fact is that the aviation industry is an increasingly global one. The efficiencies to be generated and the public services that can be performed by truly international carriers are very meaningful. Ultimately we cannot hope for effective cooperation and marketing

arrangement without some equity participation, and we cannot ask for equity participation without some share of control. Similarly, cabotage appears to be more an emotional issue than a real one, I believe. Surely, a single flight a day in a market, and one usually not aimed right for the bulk of the traffic, cannot be considered a threat to domestic airlines.

Political Issues

Finally, I think there is a political challenge that has to be met. I do not think the industry has done a good enough job explaining the need for adequate profits. The original thrust of the deregulation effort was less ideological. I think, than low fare oriented. In some ways, the growth of People Express unfortunately furthered this thinking. For a while, we though we could have it all - low fares, frequent service even to smaller cities, and an array of airlines catering to different market segments. It turned out to be a mirage, because People Express' fares were in fact subsidized by its investors. Indeed, I do not think it was accidental that the deregulation movement started in earnest during the first oil crisis in 1973 when airlines were able to raise their fares significantly at the same time that they reduced service - and made more money. That particular combination of circumstances could well lead to reregulation efforts this time around, and some punitive measures could be written into law if airline service standards deteriorate. Some were already been proposed during the service quality problems a couple of years ago. While they did not pass, their impetus could be regenerated by another service quality problem such as we had in 1987.

The Future

We have come a long way in the past ten years. In 1984, I participated in a television talk show panel on the airline industry's rapid changes. When we were finished, the moderator thanked us and indicated his desire to host a similar panel a couple of years in the future. I responded by saying that I would like to return in about ten years and then talk about the continuing turbulence in the industry. I am not sure the current environment is a turbulent one, but it certainly continues to be characterized by change, not all of which could have been foreseen a couple of years ago. I hope to be able to continue observing this exciting and evolving industry for many years.

AIRPORT CAPACITY OVERVIEW

J. Donald Reilly
Industry Task Force on Airport Capacity
Improvement and Delay Reduction

It is my great pleasure to be here today to focus our thoughts on some of the main challenges and opportunities faced by civil airports in the United States and abroad into the 21st century.

During the development of civil aviation over sixty years, airports -- relatively speaking -- have been the "no-problem", "always-there", anecdotal, or, even, footnote aspect of the industry's growth and development.

The 1990s will find this comfortable euphemistic notion radically altered. Today, airports are the Achilles heel of aviation that -- without immediate planning for massive surgery -- will lead to spreading industry trauma. The 1990s will become the "decade of the airports."

Through aviation's first fifty years the most significant changes involved aircraft technology and heavy government regulation. For the last ten years the most significant changes have been institutional as government regulation was dismantled by the Airline Deregulation Act of 1978 and global airline "liberalization."

U.S. airline deregulation initially led to expansion in the number of airlines and then, more recently, to consolidation through mergers and acquisitions. A strong group of bigger airlines have emerged, trading traditional linear route systems for some 35 connecting airport centers, or "hubs." Fares have decreased in most markets, and traffic has expanded rapidly in response to increased service and fare reductions. To meet the growing demand, fleet size and the number of aircraft operations have dramatically expanded in the U.S.

We are all familiar with the resulting traffic increases, both here and abroad. The air transportation system has become the world's major provider of public