



Aviation Insights Review (AIR): 2016 Global Industry Performance Update

Widespread Jubilation for Airline Shareholders

The global airline industry suffers constant criticism for its inability to earn a long-term profit, let alone generate economic profit (EP). But again in 2015, the industry discredited this notion not only by reporting global profits, but also by generating a significant \$24 billion in economic profit for the year.

As the leading strategy adviser to the aviation industry and expert on shareholder value analysis, L.E.K. Consulting uses economic profit (which we broadly define as the surplus that companies generate after charging for the capital they employ at their relevant cost of capital) as the relevant measure to gauge an aviation company's ability to meet their stakeholders' financial requirements over time. Although total shareholder returns are insightful, they depend too much on random start and end dates that can be adversely affected by any number of market conditions at the time.

This *Aviation Insights Review (AIR)* report provides an update on the global airline industry for the period ending 2015. Last year, the aviation industry generated a very strong and positive EP, continuing a trend that began five years earlier. Figure 1

shows the top 10 most economically profitable airlines, across all geographic regions and from each of the [different business models](#), for 2011-2015.

Furthermore, the EP margins (cumulative five-year EP divided by cumulative five-year revenue) were impressive (see Figure 2).

The sheer magnitude of the EP generated by the top 10 performers is remarkable. Other notable observations include:

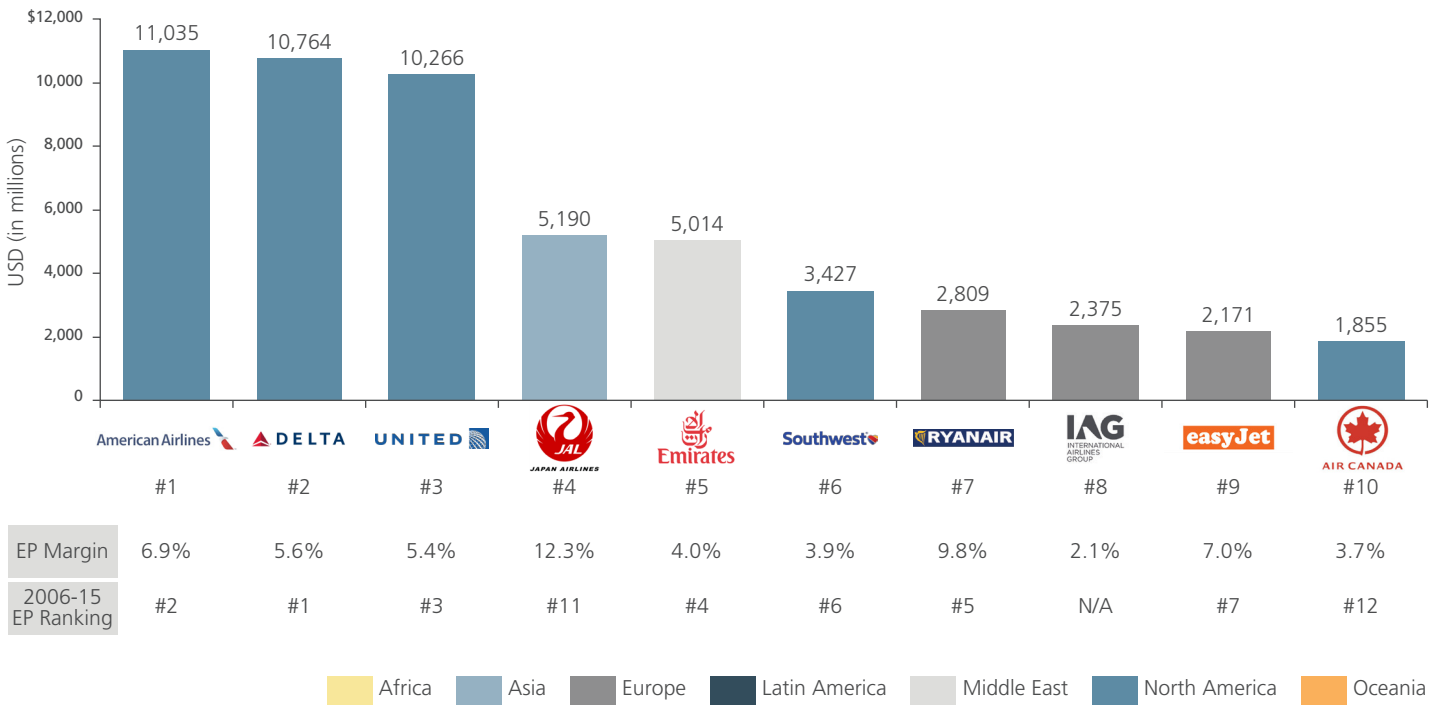
1. Of the 106 reporting airlines that we analyzed, 41 or approximately 40% are EP-positive.
2. Those 41 airlines collectively generated an astounding EP — more than enough to cover the laggards' cumulative negative EP (and unlike the laggards in prior years, the laggards during these five years were not that far in the red) — so that overall the industry generated an EP of \$24 billion.
3. Oil prices were a significant contributor to the increased EP in 2015. The benefits of cheaper oil were captured throughout all of 2015, unlike in 2014, when oil prices dropped only during Q4.
4. U.S. carriers are now undisputedly the most lucrative airlines in the world, with all major U.S. carriers generating significant positive EP.

Aviation Insights Review (AIR): 2016 Global Airline Industry Performance Update was written by **John Thomas**, Managing Director and Head of L.E.K. Consulting's global Aviation practice and **John Nevin**, Principal in L.E.K.'s Aviation practice, based in Boston.

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Figure 1
Top 10 Economic Profit Generators by Absolute Dollars (2011-2015)
41 "winners" from 106 airlines analyzed



Note: Of the 106 airlines analyzed, none from Africa, Latin America or Oceania are in the top 10 economic profit generators by absolute dollars.
Sources: Capital IQ, Bloomberg, companies' annual reports, DOT Form 41, L.E.K. analysis

- American Airlines outperformed 2014's winner, Delta, in EP in 2015, driven partially by both carriers' aircraft purchase and financing choices. American spent roughly \$1.25 billion on aircraft rent versus Delta's approximately \$250 million, which benefits American from an EP standpoint in a low weighted average cost of capital environment. What remains to be seen is how these choices will affect American and Delta if the cost of capital increased (which would increase American's capital charge) or if demand weakened (which would leave American with continued lease payments while Delta can ground its jets, a wise choice it has made in the past to minimize financing charges during softer economic times).
- The four largest U.S. airlines retained their distinction as the four largest market cap airlines in the world, although their combined market cap fell from more than \$120 billion (on April 17, 2015) to \$111 billion (on April 15, 2016), with Delta and Southwest essentially being flat and American and United incurring declines. These historically high market caps indicate that the financial markets see

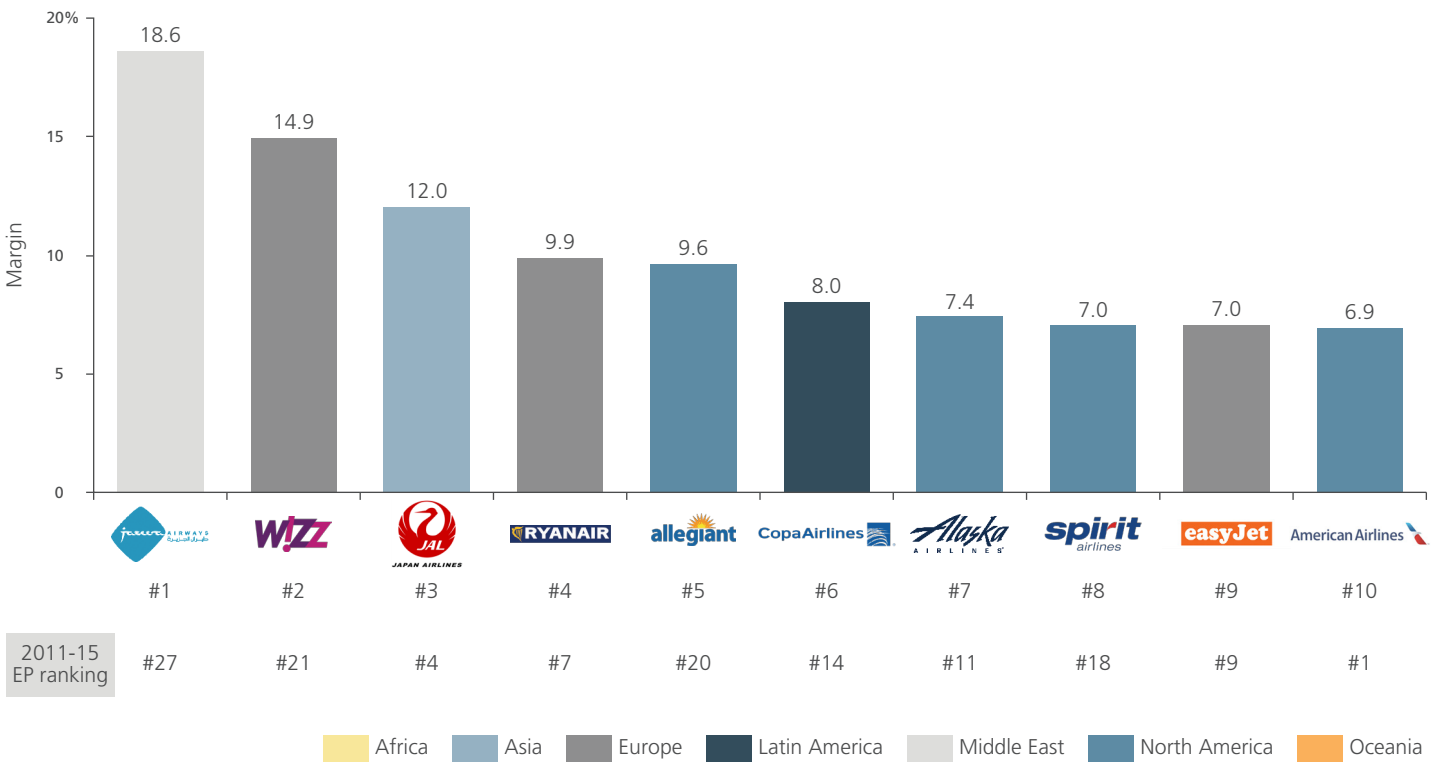
this as a fundamentally new industry with significant sustainable profit-generating capability.

- The 41 EP-positive airlines' five-year cumulative ancillary revenues far exceed their actual EP, further underscoring the critical role that ancillary revenues play in underpinning the industry's economic viability. For example, although the three most EP-positive airlines over the past five years — American, Delta and United — collectively generated approximately \$32 billion in EP, their cumulative ancillary revenues over the same five-year period totaled more than \$50 billion. In other words, even the highly successful U.S. carriers would have been EP-negative if not for ancillary revenues.

Despite substantial improvement in the aviation industry's global financial performance, carriers aren't content to rest on their laurels. We have observed a significant amount of activity by airlines to further improve their long-term financial performance by making the following bold moves:

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Figure 2
Top 10 Economic Profit Generators by Percentage Margin Over Their 5-Year Revenue (2011-2015)



Note: 5-year EP margin = 5-year cumulative economic profit/5-year cumulative revenue; Of the 106 airlines analyzed, none from Africa or Oceania are in the top 10 economic profit generators by percentage margin.

Sources: Capital IQ, Bloomberg, companies' annual reports, DOT Form 41, L.E.K. analysis

1. Accepting the benefits of forming commercial (immunized) joint ventures.
2. Migrating from ancillary revenues to merchandising, with the associated focus on product/experiential enhancements instead of takeaways (e.g., bag fees). Whereas much of the world perceives ancillary revenues as mainly takeaways, these now represent only roughly 25% of ancillary revenues generated by major carriers.
3. Moving toward greater personalization/individualization, which flight attendants on board and customer service staff on the ground can deliver.

4. Increasing industry recognition of the vital role that technology architecture plays through the common data warehouse (i.e., enabling a "single view of the customer").

The benefits of currently low oil prices will inevitably disappear over time, so the aviation industry needs to take proactive measures to ensure their EP, now and over the long term. As a leading adviser to the industry, L.E.K. applauds the industry for its widespread efforts to ensure its ability to generate sustainable, acceptable financial returns.

About L.E.K. Consulting

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. We are uncompromising in our approach to helping clients consistently make better decisions, deliver improved business performance and create greater shareholder returns. The firm advises and supports global companies that are leaders in their industries — including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. Founded more than 30 years ago, L.E.K. employs more than 1,200 professionals across the Americas, Asia-Pacific and Europe. For more information, go to www.lek.com.

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