

Aviation Insights Review (AIR) – 2013 Global Industry Performance Update

The global airline industry is constantly chastised for its inability to earn a long-term profit, let alone generate economic profit. But this perception isn't completely accurate. In its Aviation Insights Review (AIR) series, L.E.K. Consulting pays credit to those participants in the global aviation industry that have generated attractive returns to shareholders – be they full service carriers, low-cost carriers, or regional carriers.

As the leading strategy advisor to the aviation industry and expert on shareholder value analysis, L.E.K. uses economic profit as the relevant measure to gauge a company's ability to meet the financial requirements of its stakeholders over time. While total shareholder returns are insightful, they are too dependent on the random start and end dates that can be adversely affected by any number of market conditions at the time. (L.E.K. broadly defines economic profit as the surplus the company generates after charging for the capital that it employs at its relevant cost of capital rate.)

This AIR report provides an update on the period ending 2012 for the entire global industry. Given the dramatic turnaround in the U.S. industry over the past five years, we have provided two timeframes: both the 10 years and five years ending 2012. As Figure 1 illustrates, the leading industry players generated significant returns.

To reiterate, these are economic profit numbers – i.e., the returns generated *over and above* the returns that the shareholders required.

After an exhaustive study of the global airline industry, L.E.K. identified a set of strategies that these winners utilize in order to drive success. L.E.K. believes that pursuing one or more of these strategies, coupled with superior management to ensure effective execution, has delivered attractive returns for these leaders in the industry. Some strategies are situational and others are deliberate strategies that underpin these top players' superior performance, including:

- Tapping into emerging markets and being ahead of the demand curve
- Having a strong market position in a well-defined market that can include a geography or a customer segment
- Being the absolute lowest-cost producer
- Developing and nurturing a portfolio of complementary companies, and matching each company's strategy to its targeted market segment(s)
- Innovating to stay ahead of the commoditization trend
- Consolidating to gain value-creating scale

Aviation Insights Review (AIR) – 2013 Global Industry Performance Update was written by **John Thomas**, Head of L.E.K. Consulting's global Aviation & Travel Practice. John is also a member of IATA's Travelling Passenger Vision 2020 working group, which is a part of the Simplifying the Business initiative.

Figure 1

Top 10 by 5-Year Cumulative EP ('08-'12)

Carrier/Rank	Cumulative 5-year Economic Profit
1. Delta Air Lines Inc.	U.S. \$2,172 million
2. Ryanair Holdings plc	U.S. \$1,469 million
3. United Continental Holdings, Inc.	U.S. \$1,067 million
4. Copa Holdings S.A.	U.S. \$900 million
5. Westjet Airlines Ltd.	U.S. \$539 million
6. LAN Airlines S.A.*	U.S. \$448 million
7. AirAsia Bhd	U.S. \$395 million
8. Deutsche Lufthansa Aktiengesellschaft	U.S. \$361 million
9. Singapore Airlines Ltd.	U.S. \$321 million
10. Spirit Airlines, Inc.	U.S. \$300 million

Top 10 by 10-Year Cumulative EP ('03-'12)**

Carrier/Rank	Cumulative 10-year Economic Profit
1. Ryanair Holdings plc	U.S. \$2,797 million
2. Deutsche Lufthansa Aktiengesellschaft	U.S. \$2,327 million
3. Singapore Airlines Ltd.	U.S. \$1,628 million
4. Copa Holdings S.A.	U.S. \$1,174 million
5. LAN Airlines S.A.	U.S. \$774 million
6. Westjet Airlines Ltd.	U.S. \$600 million
7. AirAsia Bhd	U.S. \$371 million
8. Allegiant Travel Company	U.S. \$300 million
9. Transat AT, Inc.	U.S. \$249 million
10. easyJet plc	U.S. \$228 million

Source: L.E.K. analysis

*LAN rather than LATAM is measured given LATAM was created in mid 2012; Delta and United include Northwest and Continental respectively

**Spirit and AviancaTaca are currently strongly EP-positive; however, they were excluded from the 10-year outlook due to lack of historical data

As Figure 1 highlights, the leaders have deployed those strategies appropriate for their own circumstances. We commend Ryanair for focusing on being the absolute lowest-cost producer, Singapore Airlines for nurturing a portfolio of complementary companies as well as innovating, Copa for tapping into emerging markets but also leveraging its advantaged geographic location to develop a strong market position in a well-defined market, and Lufthansa for also nurturing a portfolio of complementary companies.

However, for this 2013 Global Industry Performance Update, L.E.K. would like to congratulate Delta Air Lines for what might go down as one of the most stunning turnarounds in airline history.

Given the unique regulatory constraints in the U.S. industry, Delta pursued the only practical strategic option open to U.S. carriers – that of consolidating to gain value-creating scale. Not only did its execution of its merger with Northwest Airlines set a new “best in class” for airline integration, but by relinquishing the golden share that Northwest had in Continental, the merger created the domino effect that resulted in the long-overdue consolidation of the overall U.S. airline industry. Delta has also embraced ancillary revenues (through true adaptation of the “merchandising model”) that have also helped transform the financial performance of U.S. airlines, delivering nearly \$10 billion in high-margin revenues to the industry in 2011.

Delta has also pursued a number of other prudent strategies that underpin its position of strength:

1. Aggressively reducing its net debt from \$17bn in 2009 to \$11.8bn in 2012. This \$5.2bn reduction in net debt led to \$300m in interest expense savings in 2012 compared to 2009.
2. Creatively and dramatically restructuring its fleet, reducing its CRJ200 fleet from 474 in 2009 to approximately 300 aircraft today (with further reductions to 125 aircraft by 2015) and wisely pursuing a mixed new and used fleet acquisition strategy with the purchase of new aircraft (737-900ER, CRJ900) and used aircraft (717, MD90).
3. Focusing its capital expenditure on direct, customer-facing benefits such as best-in-class international business class and lounge products so as to improve premium yields.
4. Building beachhead positions in key markets through equity investments in Virgin Atlantic, AeroMexico and Gol.

Delta has generated an economic profit of \$2.2bn over the past five years. The strategic plays highlighted above should help it continue to generate a solid economic profit over the next five years – something that the equity markets have clearly acknowledged given the near 60% increase in Delta's stock price over the past 12 months.¹

Delta Air Lines is proof that prudent strategies coupled with great management can generate returns that many in the airline industry have long thought impossible.

¹ As of April 24, 2013.

About L.E.K. Consulting Aviation Practice

L.E.K. Consulting is the premiere advisor to the global aviation industry and related aviation, airport, aerospace and travel ecosystems. Having completed more than 700 aviation engagements spanning airlines, airports, B&GA and aviation authorities, L.E.K. Consulting has guided companies across the aerospace value chain for more than 25 years. Just recently, the firm's expertise into some of the most complex and pressing challenges facing the industry helped five global carriers double their market capitalizations over the previous five years.

Our wide-ranging capabilities have evolved from a deep-seated commitment to unleash powerful revenue streams. Our expertise encompasses: airline M&A and consolidation, operations optimization, corporate and network strategy, new product development, ancillary revenue/merchandising, loyalty programs, customer flight experience, consumer engagement "Beyond the Cabin", and flight operations and optimization.

L.E.K. Consulting's unified global reach and methodical analysis provides senior industry executives with the confidence to make game-changing decisions in the face of market instability.

INSIGHTS@WORK™

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded 30 years ago, L.E.K. employs more than 1,000 professionals in 22 offices across Europe, the Americas and Asia-Pacific. L.E.K. 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. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.

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