



Insigneo Weekly Dispatch

# Shining Star in the Sky

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## Shining Star in the Sky

The airline industry in the United States has been a shining star this earnings season. Broadly speaking, the US airline industry can be broken into two major groups: The legacy or full-service airlines (e.g., United, Delta, and American) and the discount airlines (e.g., Southwest, Jet Blue, Spirit, Frontier, and Allegiant). Alaska Airlines is a bit of a mix of both groups. The full-service carriers tend to target business and leisure end markets, both domestically and internationally. Additionally, they also cater to premium end markets, within both business and leisure segments. The discount airlines are mainly focused on the leisure travel market, and, except for some international routes, they are mostly domestically focused. With this in mind, let us look at what we are seeing in the industry.

For the 4th quarter of 2022, United, Delta, and American airlines reported better than expected numbers, with increased earnings per share guidance and outlooks for the year. This was mainly driven by increased Operating Margins, as well as increased passenger demand expectations. First, let us dive deeper into Operating Margins. These are mainly driven by load factors (i.e., how much revenue is being generated given the airline's available seats, basically how full the plane is), yields (i.e., how much revenue is being generated per passenger on that plane) and costs (i.e., mainly labor and fuel). These three airlines are seeing stable to rising load factors and yields, and while costs have risen, they seem to be doing a good job

at mitigating expenses. Second, looking at passenger demand, these carriers should be poised to benefit from increased business and international travel. Delta estimates that there could be as much as \$30B in industry revenue upside to get back to pre-Covid levels. This does not mean that all that revenue is going to enter the industry this year, but it gives some perspective to the potential demand still available in the market. In fact, we have seen some international carriers like Lufthansa bring recently retired A380 “super-jumbo” aircraft back to service to try to meet rising demand. To that point, capacity has been structurally changed post-Covid, leading to fewer routes and thus fewer seats available to meet increased demand. Given the full-service nature of these U.S. carriers, they are likely to benefit from higher fare prices, as their customers are most likely to be able to absorb fare increases, particularly in the business and premium segments. Increased passenger demand and higher fare prices should lead to higher load factors and higher yields, resulting in further improvements in Operating Margins. Lastly, we are also seeing these companies upgrade their long-range aircraft fleets, leading to higher cost efficiencies. United recently announced an order for 100 Boeing 787 jets to replace older 767 and 777 aircraft. Closer to home, we saw American Airlines do the same when it replaced older aircraft for the newer 787 in its Miami-Montevideo route and added the same type of aircraft to its Dallas-Buenos Aires route. Delta could be considered the best operator of the group, with the highest EBITDA margins, but United is doing a great job at repositioning its operations. United is focusing on increasing its footprint in international routes, where capacity rationalization is leading to fewer players in the industry,

particularly in Europe and Asia. Capacity rationalization generally refers to the intentional limiting of available seats in the industry. The company should benefit as these regions continue to emerge from Covid-19 pandemic. American Airlines should also benefit from the industry trends described above, particularly in Latin America. It is important to keep in mind that American Airlines does carry relatively higher levels of debt than its full-service peers. However, the company’s new Chief Financial Officer recognizes this, and appears intent on repairing the company’s balance sheet.

The discount airlines should also benefit from increased demand and reduced capacity, but potentially to a lesser extent than their full-service competitors. Discount airlines have less pricing power, as their predominantly leisure end market is less likely to absorb fare increases. Given the relative lack of presence in international segments, the discount airlines are also most likely to be negatively affected by a recession or slower growth in the United States. In fact, Jet Blue spoke of lower-than-expected demand for its routes, something we have not seen for the full-service carriers. The airline also saw costs increase more than expected, further cutting into profits. Additionally, the discount airlines are currently experiencing a number of idiosyncratic risks that could lead to a higher degree of volatility relative to peers. Jet Blue is in the process of attempting to acquire Spirit, an acquisition that is being reviewed by the Department of Justice and could go into next year, potentially creating unwanted “noise” for both airlines. Southwest is still reeling from its recent flight cancellation issues and could potentially see operational issues impacting near-term earnings.

In fact, recent high cancellation rates among the discount airlines could lead to more discontinued routes, further increasing capacity constraints. On the other hand, Alaska Airlines, a more hybrid carrier, does cater to a relatively higher amount of business travelers. However, these travelers tend to be predominantly located in the West Coast of the

country and focused on the Technology industry, which could be negatively impacted by increased layoffs. Allegiant Air was the lone discount airline that posted an above average quarter, benefiting from increased demand, as it saw customers shift over from Southwest Airlines.

	Revenue Passenger Miles	Available Seat Miles	Load Factor	Yield per Passenger Mile
<b>Full-Service Carriers</b>				
American Airlines Group Inc	55.32B	65.96B	83.90%	21.93%
Delta Air Lines Inc	50.48B	59.51B	85.00%	21.57%
United Airlines Holdings Inc	54.76B	64.29B	85.20%	20.46%
<b>Discount Carriers</b>				
Southwest Airlines Co	31.30B	37.49B	83.50%	17.70%
Alaska Air Group Inc	12.86B	15.03B	85.50%	17.61%
JetBlue Airways Corp	13.70B	16.47B	83.20%	16.55%
Allegiant Travel Co	3.58B	4.36B	85.30%	15.78%
Spirit Airlines Inc	10.43B	12.87B	81.00%	13.34%
Frontier Group Holdings Inc	7.12B	8.67B	82.10%	12.45%

Source: Bloomberg, Insigneo

As of January, of this year, sales rose 72% for the full-service carriers and 52% for the discount airlines, compared to last year. As would be expected, EBITDA margins over the same period were also higher for the legacy carriers, coming in at 10.3%, compared to 8.1% for the discount airlines. As we can see on the table, the full-service carriers have better metrics than the discount carriers, including higher revenues (i.e., Revenue Passenger Miles), higher capacity to increase revenues (i.e., Available Seat Miles), as well as higher revenue yields. The legacy carriers do trade at slightly higher valuations than the discount airlines, but both stand at reasonable levels. Although increased passenger demand and capacity constraints could benefit the

US airline industry as a whole, we believe that the full-service carriers could stand to benefit the most. It is important to keep in mind that a deeper than expected domestic or global recession would likely have a negative impact on the U.S. airline industry. As such, these stocks are best suited for clients that can tolerate a relatively high level of risk.



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