



Outlook for Airlines: Consolidation, Regulation and Revenue Generation

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Stuart Feil, Editorial Director, Forbes Insights

Elliott Forrest: Welcome to 5 Minute Capital (www.5minutecapital.com), CIT's executive insight series, which takes on financial issues in about five minutes.

Today we're discussing the second in a two-part series focusing on CIT's 2011 Global Aerospace Outlook study (www.cit.com/aerospaceoutlook).

We welcome to the studio **Jeff Knittel**, President of **Transportation Finance** at CIT, and **Stuart Feil**, Editorial Director of Forbes Insights. Good to see you both.

Jeff Knittel: Thank you, Elliott.

Stuart Feil: Thank you.

Forrest: What activity do airlines expect on the M&A front?

Feil: Eighty-one percent of the executives that we surveyed said that they expect to see either a significant increase, or an increase, of consolidation over the next five years. We asked them why they expect to see this and what was going to drive it, and marketing synergies was the top response. Number two, interestingly, was the need to optimize labor efficiency and cost, cited by 43% of respondents, and number three was the opportunity to optimize fleet capacity, cited by 42% of respondents. But these are, again, really issues related to efficiency and cost.

Knittel: We continue to look at an increasing amount of consolidation on the M&A front. We think the reasons for that are really twofold. One, the benefits they see in terms of marketing and revenue enhancement, but just as importantly the cost savings of having a larger airline and having more cost and efficiency levers to pull. We would expect, over time, to see a continuing amount of consolidation in the industry.

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Forrest: Will the consolidation mean more routes for customers or less?

Knittel: When you look at consolidation over time, I think what you are going to see is a better fit between the route networks of the airlines and demand. As airlines become more efficient, you will see load factors continue to increase. The reason is they will have a better marketing opportunity up front, but having a larger network, and in some cases a global network, will give them a better pool to fill those airplanes. So, ultimately we think we are going to see airlines continue to expand, but they will be very efficient in their expansion.

Forrest: Stuart, a major concern from the airline executives in your study was about regulatory issues. Do you want to tell us about that?

Feil: We asked about what regulatory issues they are concerned with, and number one was regulations to curb carbon emissions. So that is something really related to fuel, which I know is something we have discussed, and fuel costs. As one executive said, “They can hedge against fuel costs, but they can’t hedge against carbon emission regulations at this point,” and that is one of the drivers as to why they are looking for more fuel efficient aircraft.

Forrest: Is that likely to happen with this Congress?

Knittel: I think we have to look at it globally, but clearly there is pressure around the world to be greener, especially if you go to Europe—a lot of the airports are already taxing aircraft for inefficiency. Ultimately, you are going to drive down the amount of gases in the environment by using less fuel and that is done by having more efficient aircraft in general that are flying in a more efficient system. So the combination of having more efficient aircraft in a more efficient system—specifically, better route networks, better air traffic control, better infrastructure on the ground—will allow airlines to burn less fuel, and the result of that is obviously less greenhouse gases in the environment.

Forrest: What other regulatory issues were the airline executives concerned about?

Feil: There is the discussion of airplane noise levels. Certainly, that is an area of concern, and I think that is also something that they are looking at in terms of the new technology as a means of solving that.

Knittel: The engine manufacturers and the airframe manufacturers in general have done a very good job of improving the noise footprint of aircraft over time. The first noise rules really came about globally in the early eighties and have since, every five to ten years, increased, and with that the manufacturers have been able to come up with ways to lower the over-all noise footprints, specifically footprints that affect people who live around airports. I think that is good news overall, and the industry has invested a lot of time and money in trying to accomplish it.

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Forrest: What did the study find regarding leasing?

Knittel: There is clearly a trend toward increased leasing. When you go back into the early eighties, the leasing business was essentially long-term leasing. Now people are looking at different leasing products and specifically the operating lease product, which allows airlines to have financial flexibility, but also operational flexibility. When they look at their fleets in terms of five- or seven- or ten-year increments, they can do a more efficient job of creating flexibility in terms of where they want to drive their airline—whether it is to bigger airplanes, which is a trend we are seeing in general. As airlines try to become more efficient, one of the things they are doing is growing slightly the types of airplanes they utilize, and that allows them to drive their cost down. And so this is part of the overall trend that we are seeing.

Forrest: So this continues to be an important part of their business?

Knittel: From our perspective, we see it as a growing part of the business—and airlines today are demanding more flexibility in terms of how to manage their fleets, and an operating lease allows them the flexibility to do that. When you look at an aircraft asset, it tends to be a 25-year useful life asset, or longer in some cases. It is hard to look out 25 years and say that is going to be my fleet decision over that period of time. One of the ways to solve that is to do an operating lease that would give you the flexibility of changing your fleet in a period of five to ten years. I think airlines are realizing that flexibility is important as they try to maximize their profitability and also de-risk their business in periods of down turns.

Forrest: I think what we see as consumers is that I am being charged for everything. Will that continue and what other alternate revenue streams are they looking for?

Feil: It all really comes down to ancillary revenue for the airlines, Elliott, and we asked about what they are charging for that they didn't charge for two years ago. Three-quarters of the U.S. respondents said they are charging for first checked bag, which is interesting because that is not the case with what we were seeing with the carriers from Europe and the carriers from other regions outside of Europe and the U.S. So overall it is 38%, but three-quarters of those are U.S. Other areas like headsets, where there are an increasing number who are charging for that. Food on the flight. It is just another potential form of income and regular income for the airlines.

Forrest: What is kind of annoying for the customer frankly seems like a drop in the bucket for the airlines. Is this worth it, Jeff?

Knittel: It is clearly worth it. You are seeing certain airlines generating an additional 10 to 30 percent of revenue from that. And I think instead of looking at it in terms of extra revenue from an airline's perspective, I think you have to look at it in the case of legacy airlines specifically as a way for them to charge for a core product and people to pay for things as they want them. There are certain passengers that only want a seat. They get on the airplane, they have a carry-on bag, and they want the

lowest possible fare. There are other people that when they get on an airplane, they want to have the ability to take on as many bags as they like, they want to have a certain food service, they want to have movies and the like. That all has an inherent cost. There are only two ways to solve that. One, to charge everybody for that, or to specifically charge for the products that you provide, which I think is the appropriate way to price the product, and it allows people to get what they pay for.

Forrest: Jeff Knittel, President of Transportation Finance at CIT and Stuart Feil, Editorial Director of Forbes Insights. Thank you so much for being here.

Knittel: Thank you.

Feil: Thanks, Elliott.

Forrest: You can get more insights from the CIT 2011 Global Aerospace Outlook by downloading the report at cit.com/aerospaceoutlook. Thanks for listening. I'm Elliott Forrest. This has been a production of CIT.



C. Jeffrey Knittel is President of **Transportation Finance**, a diversified organization that provides financing solutions for the aerospace and rail industries, including commercial airlines, business aircraft operators, aerospace and defense manufacturers and suppliers, railroads, and shippers.