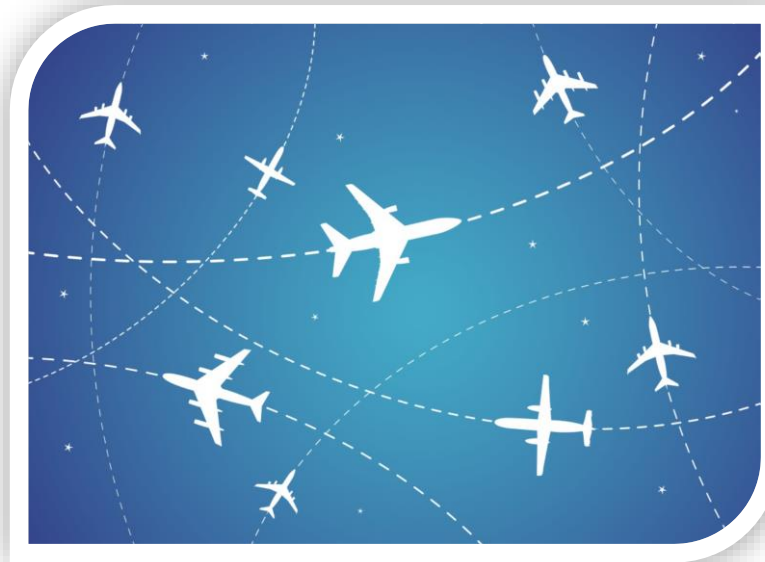




Flying High In Uncharted Skies



David Newman, Head of Research, The Murray Wealth Group

Private Client Wealth Management, www.tmwg.ca

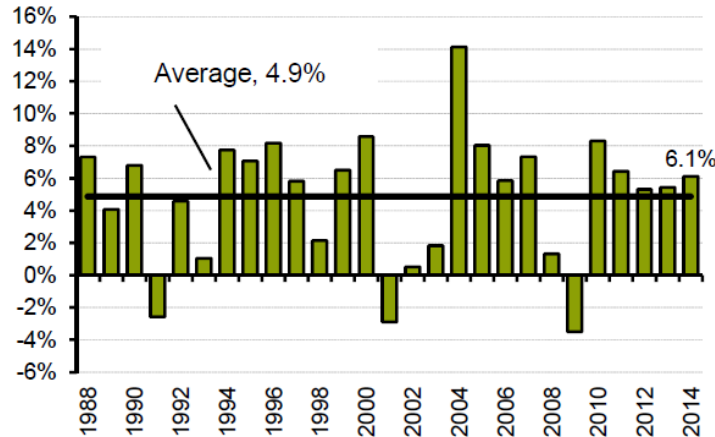
May 29, 2015

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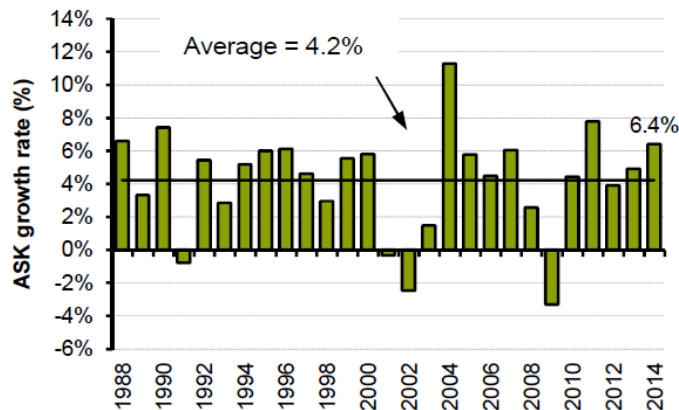


Airlines: Demand-Supply Report Card

Global international revenue passenger kilometer (RPK) history



Global international available seat kilometer (ASK) history

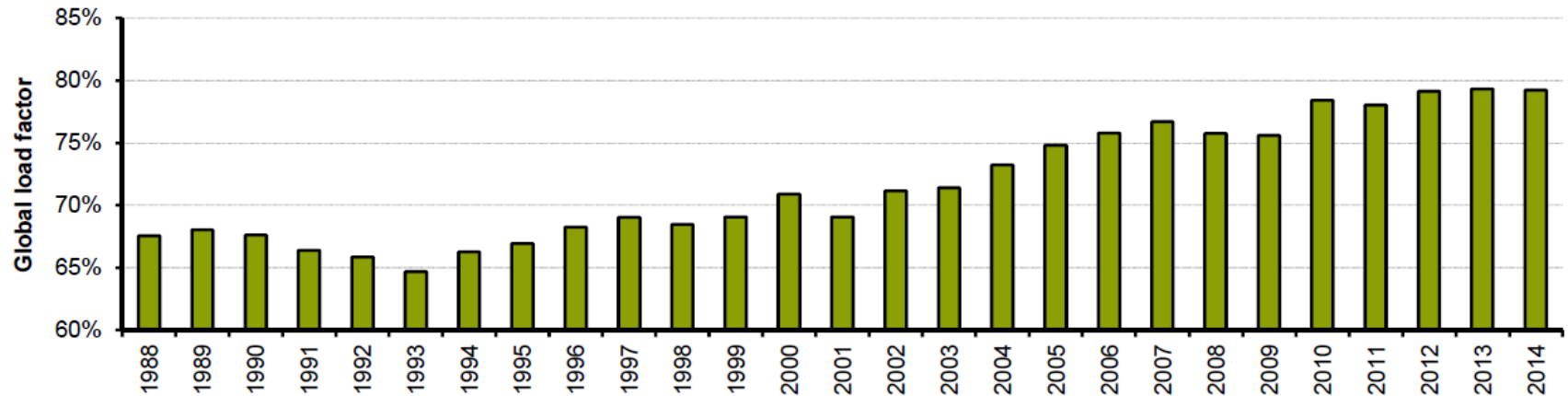


Source: IATA, Bernstein analysis

- Demand for commercial airline travel continues to grow at an above average rate.
- International travel grew by 6.1% in 2014 versus the long-term average of 4.9%. This is typical of non-recessionary periods.
- Airline capacity (as measured by ASKs (available seat kilometres)) has been growing at a relatively similar pace to traffic (RPKs (revenue passenger kilometres)).
- During 2014, capacity growth of 6.4% exceeded the long term average of 4.2%.

Load Factors On Automatic Pilot

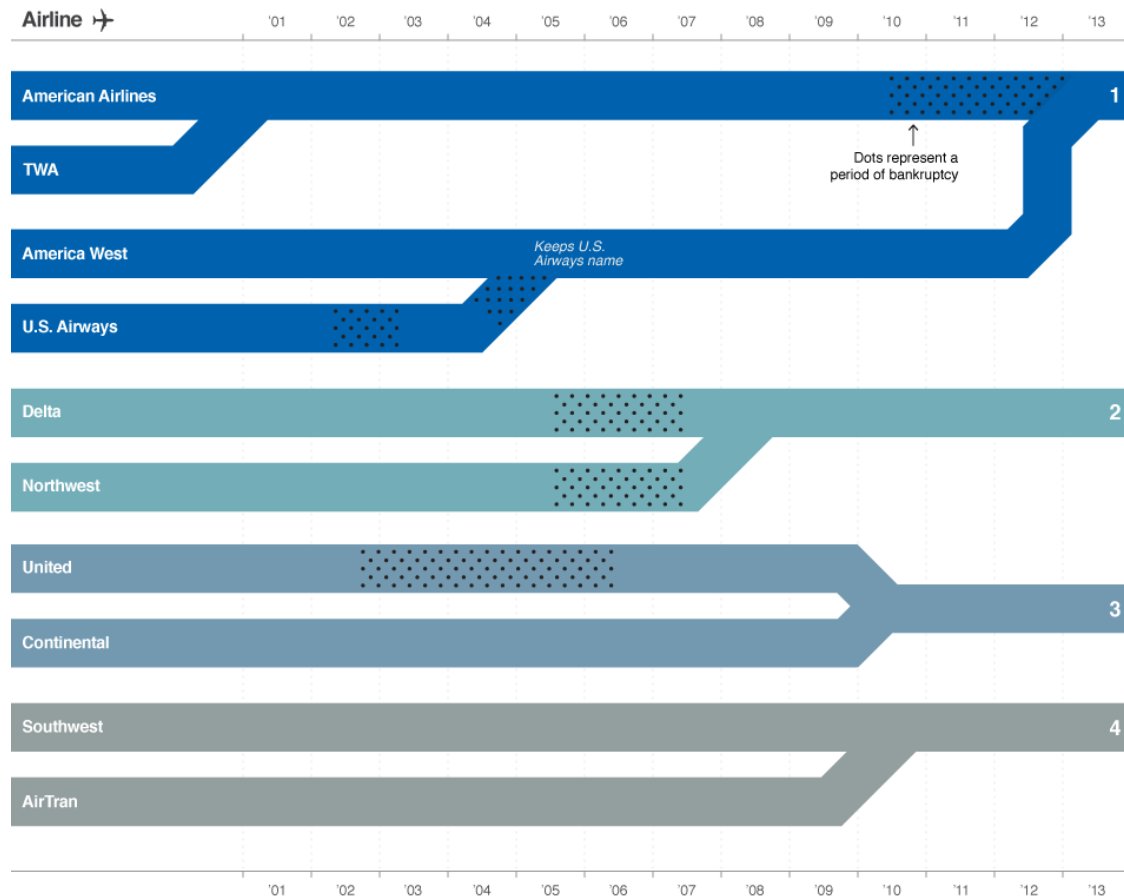
Global international passenger load factor (PLF) history



Source: IATA, Bernstein analysis

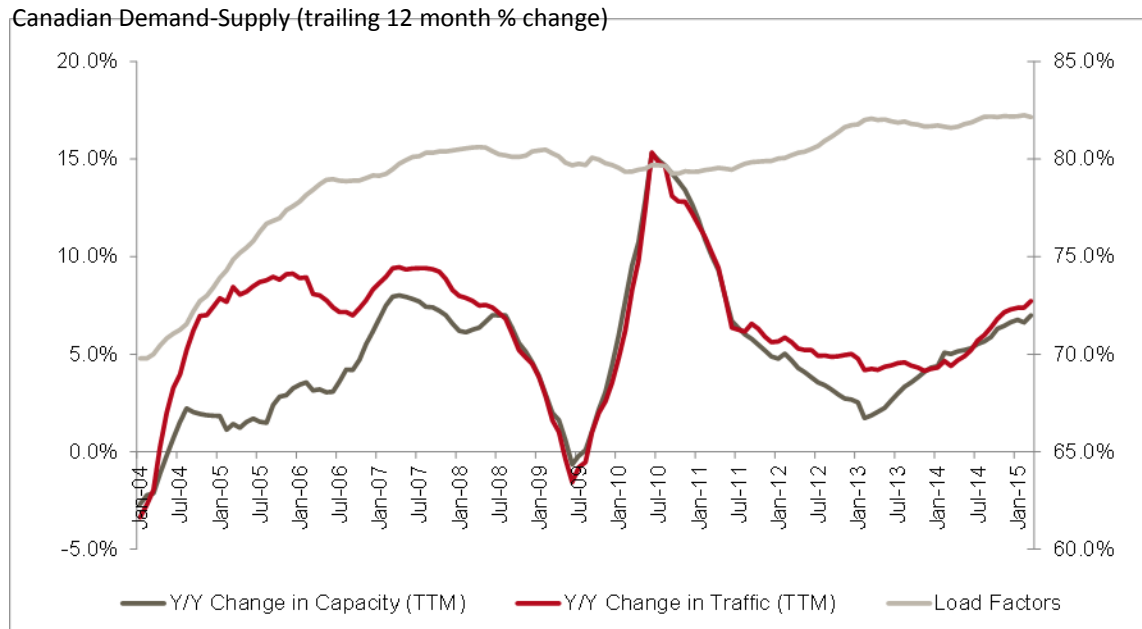
- Passenger load factors have plateaued since around 2010 around the 80% level, which is in the “optimal” zone.
- Difficult to push load factors higher due to “spilling” (do not want to lose the higher priced last minute traffic), seasonality and other factors.
- Airlines behaving more rationally in terms of capacity deployment to ensure continued and growing profitability and higher returns on invested capital (ROIC).

Consolidation Resulted In Greater Market Power



- Consolidation has led to a more rational environment, improved loads and yields, profitability, cash flows, balance sheets and returns.
- Consolidation has re-balanced power, with the remaining carriers utilizing their market power to strike deals with manufacturers, financing sources, maintenance (MRO) and suppliers, employees, distribution channels and customers.
- Investors benefitting through greater share appreciation, dividends and buybacks.

Canadian Demand-Supply Picture



Source: Cormark Securities

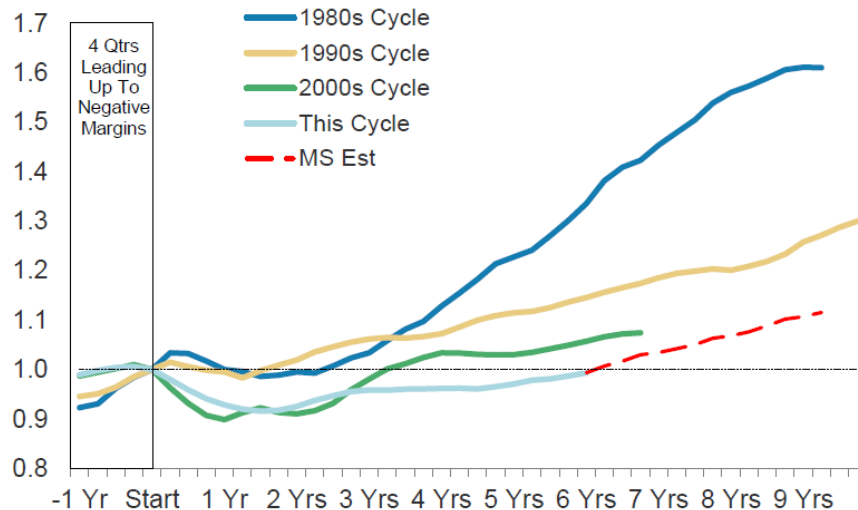
- Despite concerns that Canadian airlines are behaving less rationally than their US counterparts, capacity is being managed well, tracking demand and keeping load factors healthy.
- Again, load factors appear to have plateaued.

- In Canada, Air Canada's roll out of *Rouge*, along with the addition of new aircraft (Boeing 777s, 787s), is more skewed towards international, as opposed to the domestic markets, while WestJet's roll out of its Encore regional subsidiary is focused on much smaller markets.
- While capacity at first blush may seem excessive, it is generally not head-to-head capacity.

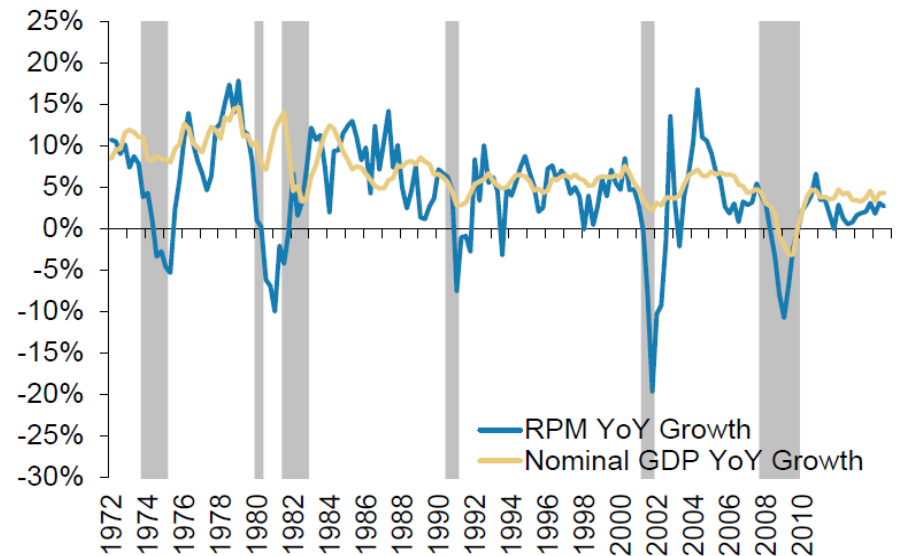
Economically Sensitive

- The airline industry is highly cyclical, sensitive to movements in GDP, trade, etc.
- Rise in share prices stalled out more recently given US dollar strength and rally in oil prices from recent lows. Plus, Southwest announced greater than expected capacity additions in 2015.

Cycle Comparison: Indexed Capacity



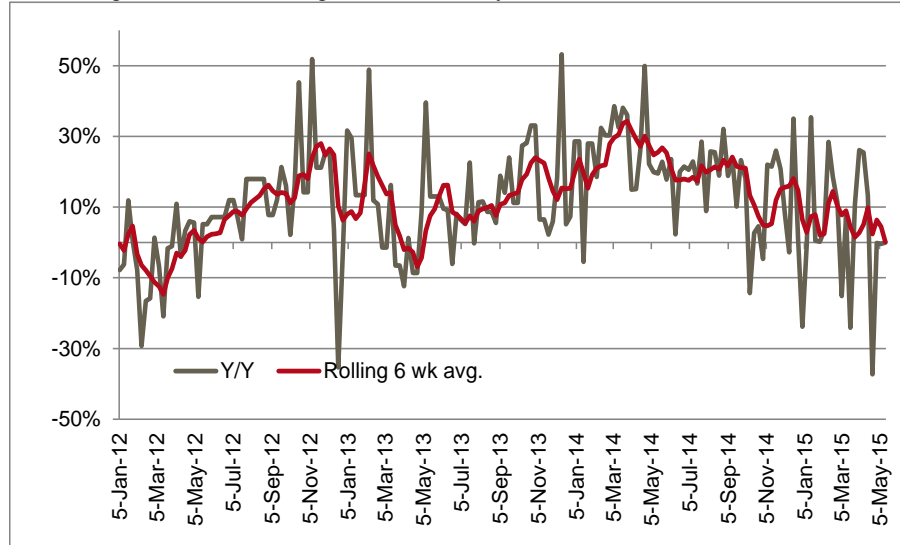
Air Travel Demand vs. Nominal GDP Growth



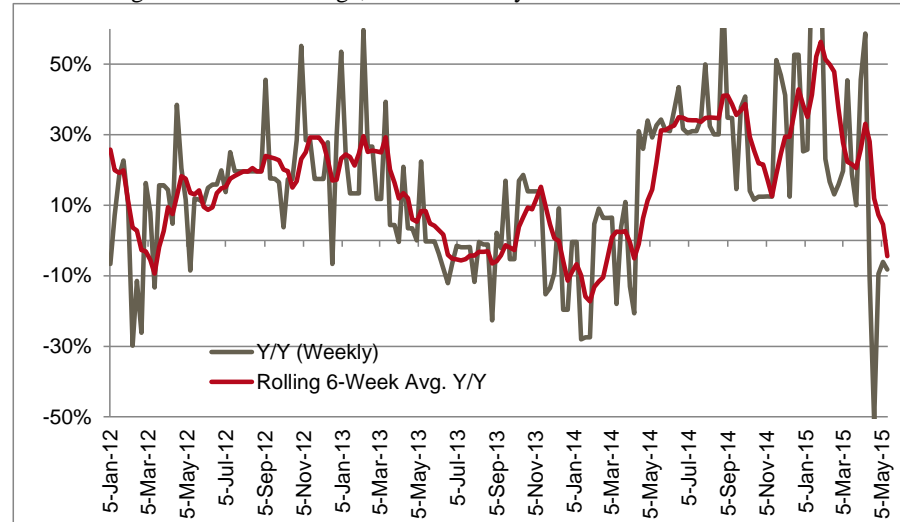
- The industry has been more rational this cycle, leading to stronger revenues, margins, cash flows and returns.
- Average recovery and expansion cycle of 6.5-7.0 years, generally followed by 3.5 years of decline and finally contraction.
- Lots of fuel still in the tank ...

Fares Reflect Balanced Approach

AC Pricing Index – Y/Y Change, Domestic Only



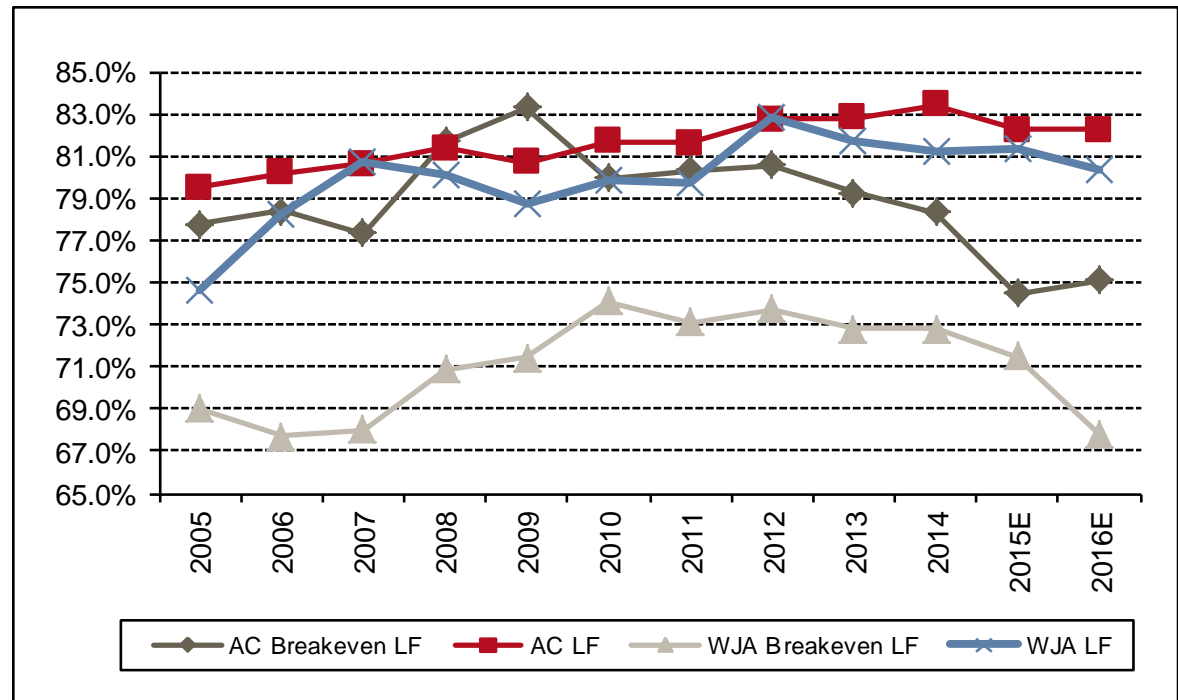
WJA Pricing Index – Y/Y Change, Domestic Only



- Disciplined capacity management allowed airlines to raise ticket prices over the last several years.
- Prices appear to be trending towards being relatively flat Y/Y.
- The industry is facing several concerns, especially in Canada:
 - Economic softness, especially given low commodity prices.
 - A weak Canadian dollar, which could stymie outbound travel.
 - Concerns Canadian carriers have not reacted to tougher outlook by reigning in more capacity, while US carriers have been relatively more rational (recently pulled capacity out of the international markets).

The Lines Are Blurring

- Witnessing some convergence in unit costs between legacy and low cost carriers as fewer legacy players in a consolidated industry leverage scale and strength, as well as discipline, to close the gap with LCCs, many of which have hit a market share ceiling and are morphing their offerings to look more like legacy carriers.



Source: Cormark Securities

- WestJet building a presence in regional (Encore), international (Boeing 767s) and targeting premium paying business travellers (Plus offering, etc.).
- Legacy carriers taking a page out of the low-cost carrier playbook to drive unit costs, excluding fuel, to lower sustainable levels.

The Lines Are Blurring ... continued

Airline Characteristics

- The golden age of aviation was turned on its head with the advent of low-cost carriers, which left many legacy carriers in their vapour trails.

Legacy Carriers vs. Low-Cost Carriers

Legacy Carriers

- First Class / Business Class Seating
- Hub-and-Spoke Networks
- Wide Range of Origins & Destinations via Short and Long-haul Flights
- Higher International Exposure
- Frequent-flyer Programs
- Typically Operate a Wide Variety of Aircraft
- Use of Main Airports with Exclusive Lounges

Source: Morgan Stanley

Low-cost Carriers

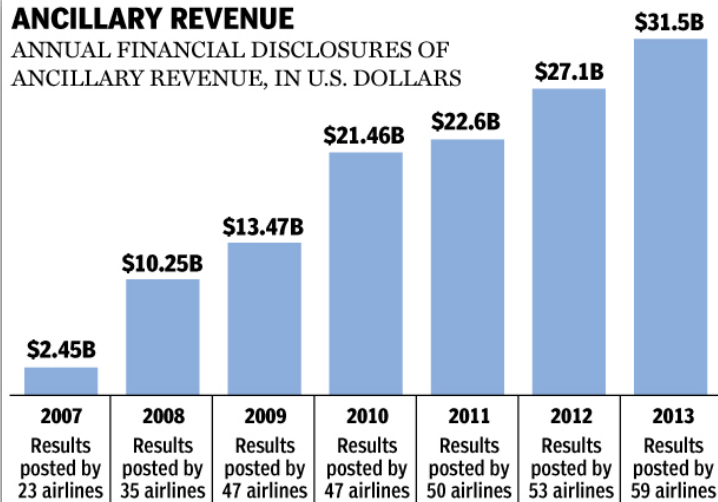
- Low Fares
- Point-to-Point Flying
- High Flight Frequencies
- Single Passenger Class
- Unbundled Fare Structure, More “Ancillary” Revenue Sources
- Most Operate a Single Type of Aircraft
- Short-haul Flights
- Use of Secondary Airports

- LCC fares are still competitive, based on lower costs, but the offerings are converging, point-to-point has given way to greater network development, the single class cabin is now witnessing the introduction of premium seating/offerings, fleets are morphing with the introduction of new aircraft types and most are flying into major hubs.
- Now seeing rise of ultra low-cost carriers (ULCC), like Spirit and Allegiant, and in Canada the recent attempts by Canada Jetlines and Jet Naked. The next wave...

Growing Ancillary Revenue Through Unbundling

ANCILLARY REVENUE

ANNUAL FINANCIAL DISCLOSURES OF
ANCILLARY REVENUE, IN U.S. DOLLARS



TOP TEN AIRLINES

BY TOTAL ANCILLARY REVENUE, 2007 - 2013,
IN MILLIONS OF U.S. DOLLARS

2007 RESULTS

1	United	\$600.0
2	Ryanair	\$521.4
3	easyJet	\$272.8
4	Alaska Air Group	\$194.2
5	Aer Lingus	\$91.3
6	Air Berlin	\$83.7
7	Korean Air	\$79.7
8	WestJet	\$78.6
9	Australian	\$77.9
10	Alitalia	\$71.1

2013 RESULTS

1	United	\$5,703.0
2	Delta	\$2,528.2
3	American	\$2,079.0
4	Air France/KLM	\$1,714.6
5	Ryanair	\$1,689.5
6	Southwest	\$1,623.5
7	easyJet	\$1,385.0
8	Lufthansa Group	\$1,282.7
9	Qantas Airways	\$1,273.4
10	US Airways	\$1,102.7

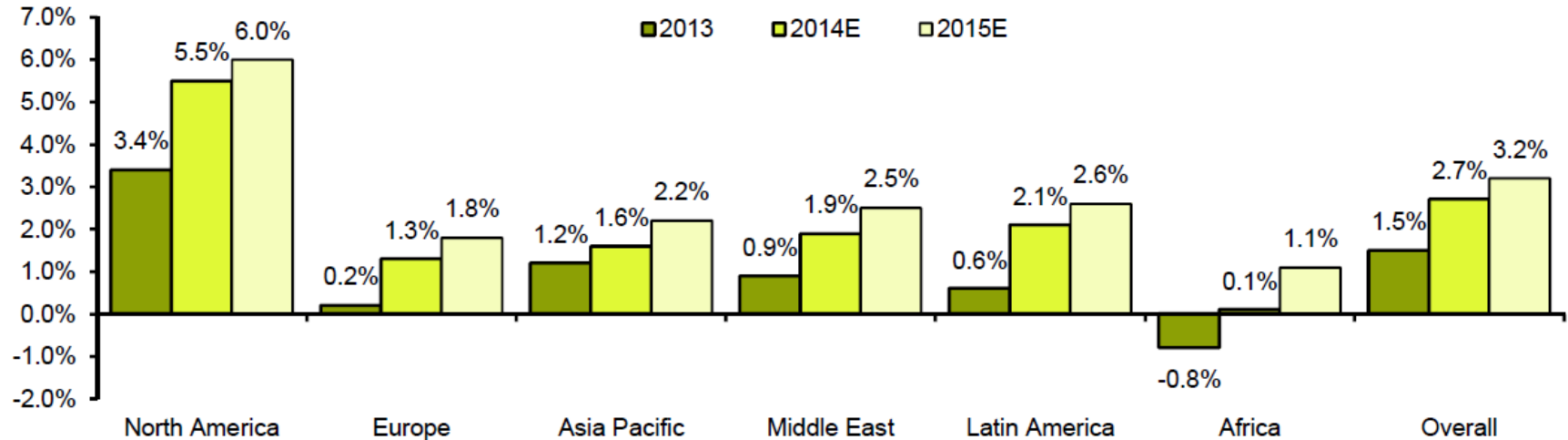
SOURCE: IDEAWORKSCOMPANY.COM

NATIONAL POST

- While maintaining ticket prices and utilizing fare buckets as a mix lever, airlines are increasingly generating revenue through ancillary revenue.
- Ancillary revenue is comprised of: 1) a la carte features, 2) commission-based products, 3) frequent flier activities, and 4) advertising sold by the airline.
- A la carte: 1) onboard sales of food & beverage, 2) checking of baggage and excess baggage, 3) assigned seats or better seats such as exit rows, 4) call center support for reservations, 5) fees charged for purchases made with credit cards and change/cancellation, 6) priority check-in and screening, 7) early boarding benefits, 8) onboard entertainment, and 9) wireless internet access.
- The list continues to grow...

Airline Profitability Gains Altitude

Airline 2013, 2014E, and 2015E average post-tax profit margin



Source: IATA, Bernstein analysis

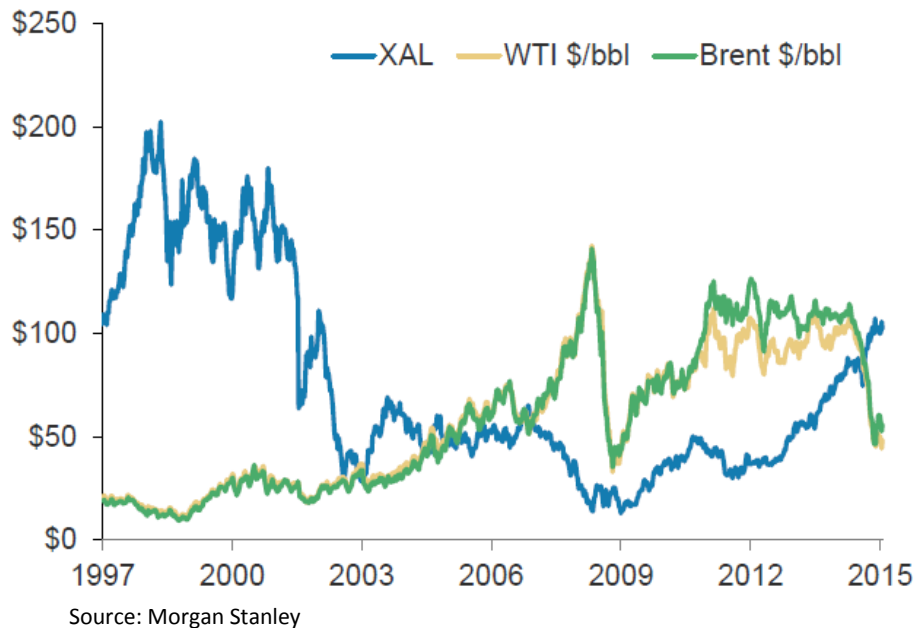
- Airline profitability continues to rise. Expect record profitability of US\$25 BB in 2015, based on Brent crude price of US\$85/B, although with oil well below this level, the number should skew upwards.
- Demand remains strong despite weak commodity prices, with the offset being consumers have more money to spend, the US economy is strong and the EU is slowly recovering. China has decelerated. The C\$ could hurt outbound, but Canadian carriers could benefit from greater sixth freedom traffic on transborder, with clear evidence of traction.
- Huge backlogs at Boeing and Airbus at eight years of production should keep supply side in check, but production rates climbing after years of relatively rational output.

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Low Oil Prices Helping To Fuel Strong Profits

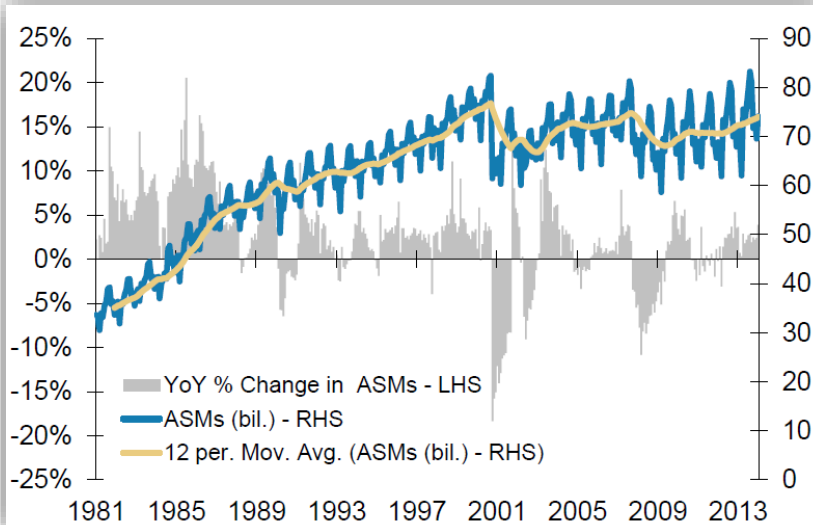
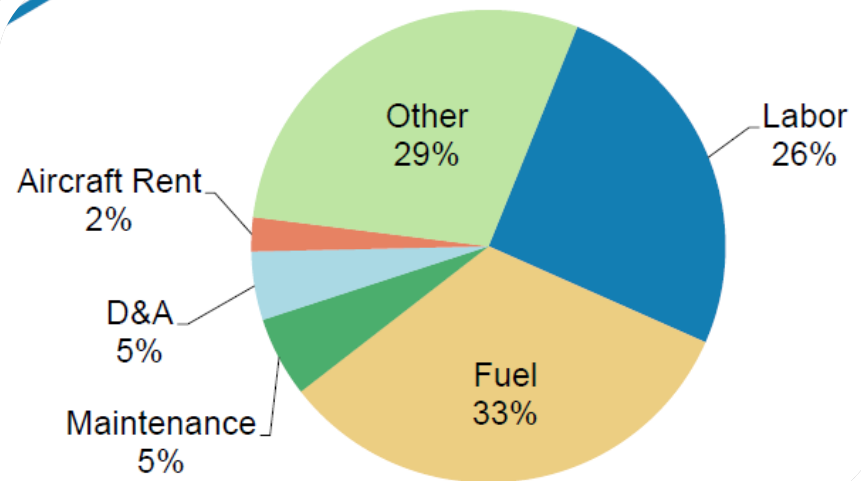
Airlines vs. Oil Prices



- Low oil prices have fuelled the rally in airline share prices, given fuel represents around 33% of costs.
- Rise in share prices stalled out to a degree more recently given US dollar strength and rally in oil prices from recent lows + capacity concerns.
- Airlines are attempting to keep ticket prices relatively intact to enjoy above average profits.
- Strong cash flows will be utilized to deleverage on and off balance sheet debt (including pensions), buy back shares and raise dividends.
- Over the past five years, dividends for the industry have increased 143%, according to Thomson Reuters data.

Not Just Fuel Prices Though

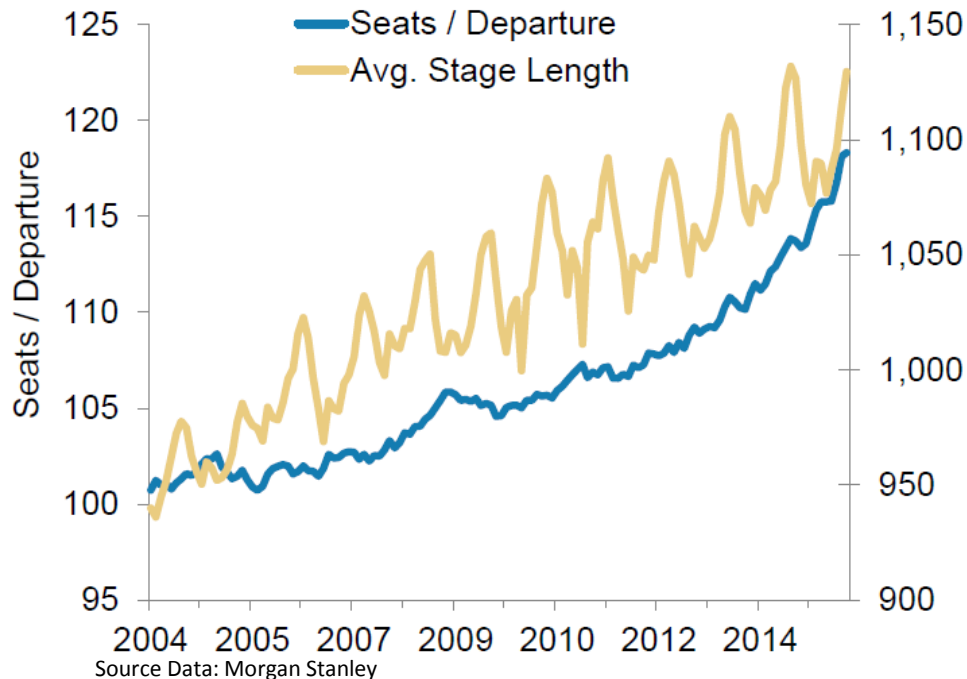
- Besides greater capacity discipline to drive loads and fares, ancillary revenues and fees, and the benefit of lower fuel costs, the airlines have become far more disciplined with cost management.



- Lower costs driven by: 1) up-gauging of aircraft, 2) network and fleet optimization, 3) re-striking contracts with various suppliers, 4) increasing labour productivity and lowering labour costs, aided by investment in technology, 5) some scope clause relief, 6) easing debt and pension burden and other.

Go Big Or Go Home = Scale, Scale, Scale

US Industry Seats/Departure and Average Stage Length



- Airlines overhauling fleets with new aircraft to reduce unit costs.
- Buying larger long-range wide-bodies to expand international horizons and increase stage lengths, e.g. 777, 787, A350, etc.
- Airlines are progressively replacing 50-seat regional aircraft with 75- to 100-seat regional aircraft, especially given scope clause relief.

In The Cabin, Go Small Or Go Home

- Since 2009, airlines have increased their average seats per departure 11.5% by up-gauging aircraft to larger equipment, reducing seat pitch and adding slim-line seats (lowers weight).
- = sardines in a tin can especially given load factors, charge for luggage, etc.

SITTING LOUSY



SOUTHWEST
Added an additional row on most of its fleet, taking about an inch of legroom per passenger.

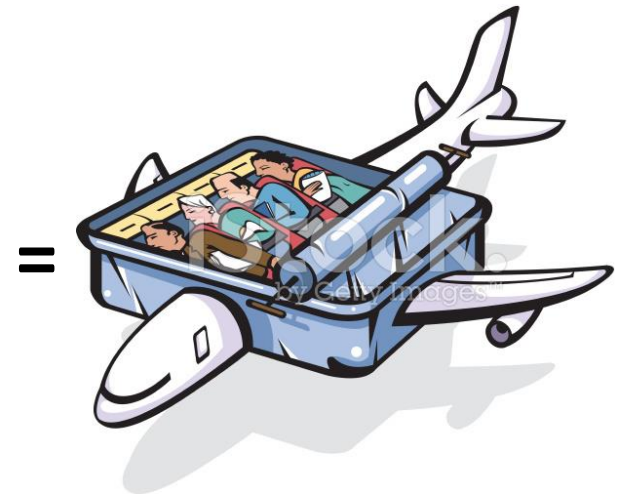
U.S. AIRWAYS
Added four seats to its Airbus 321.

American Airlines
Five more seats on MD-80 planes by next month.

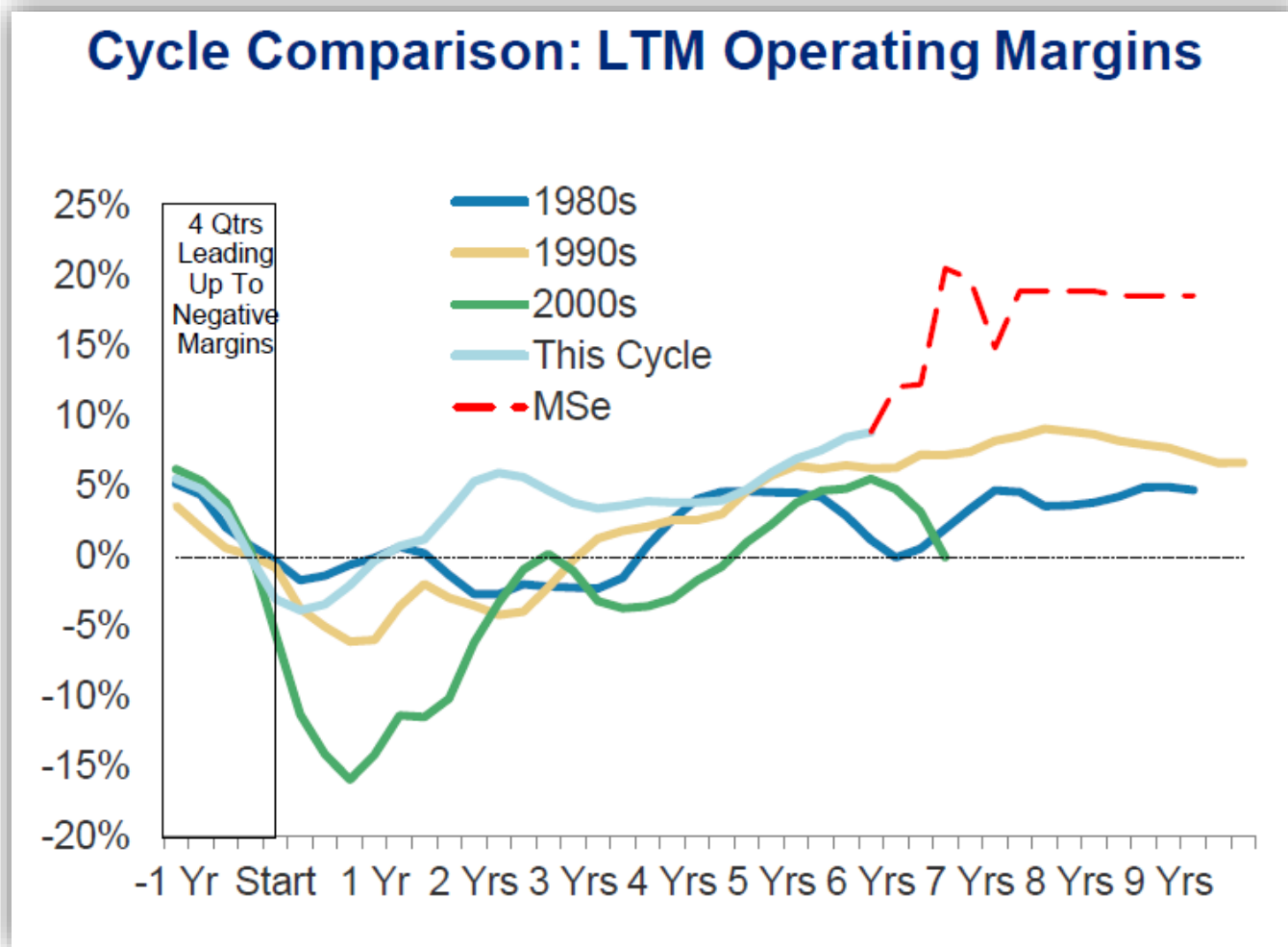
DELTA
Changing to slim-line seats on MD-90s, Boeing 737s, 747s and some 757s.

jetBlue
Plans to replace seats on Airbus A320s.

Alaska Airlines
Adding an extra row in its Boeing 737s.

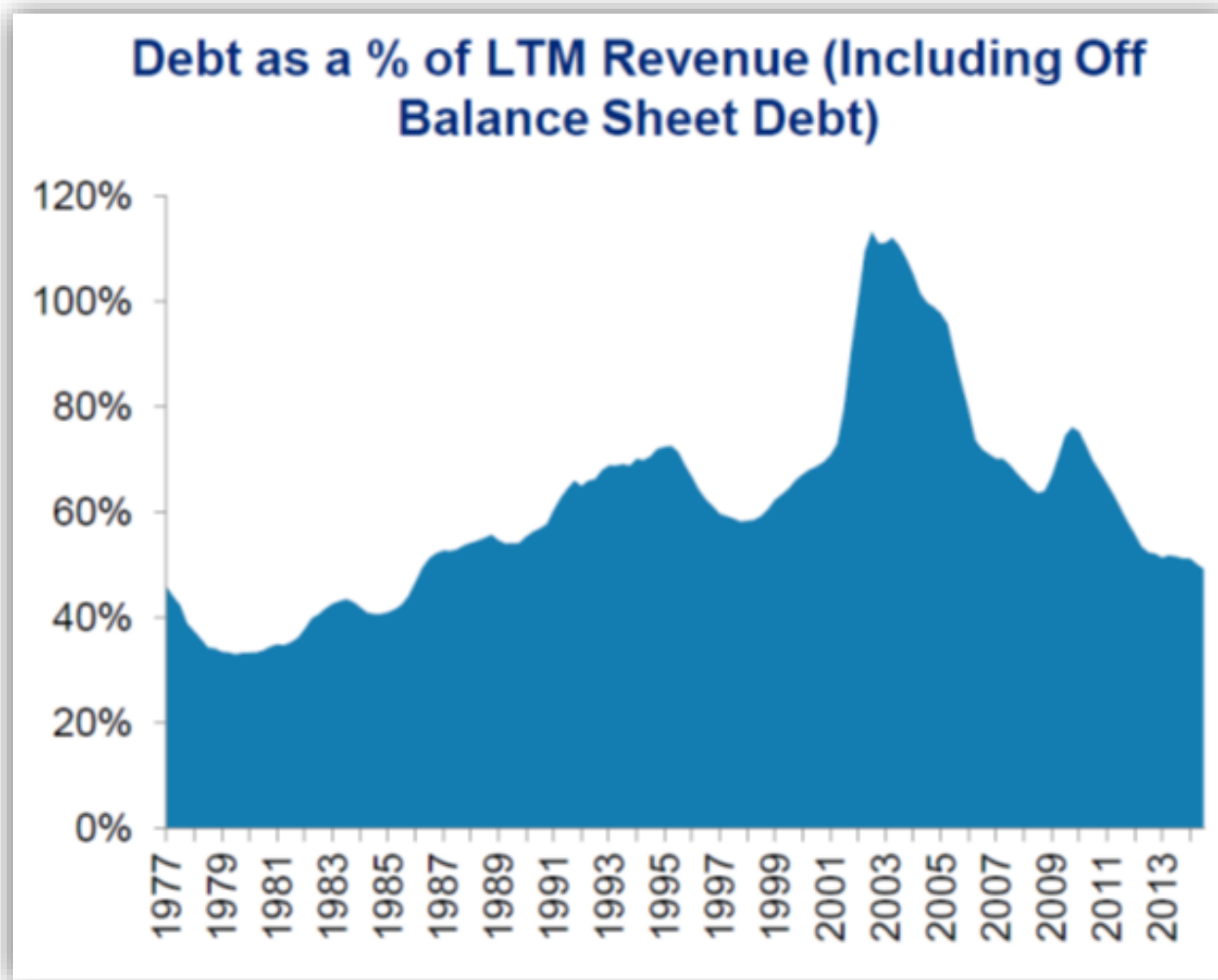


Translates Into The Best Margins Ever ...



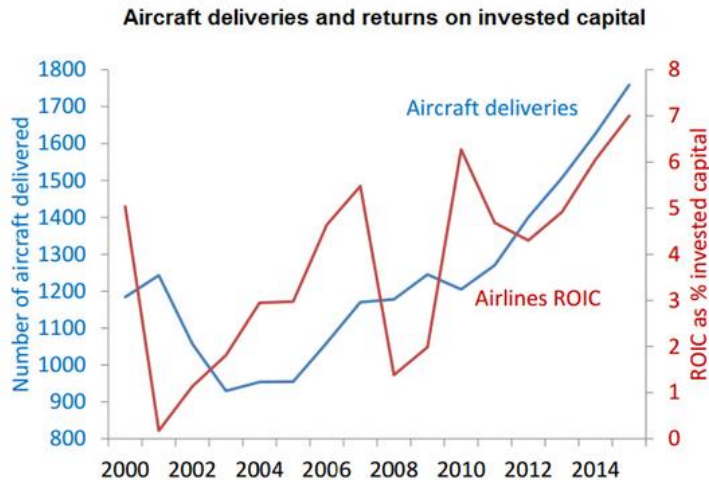
Source Data: Morgan Stanley

... And Cash Flows To Progressively Deleverage



Source Data: Morgan Stanley

Improving ROIC, But < WACC

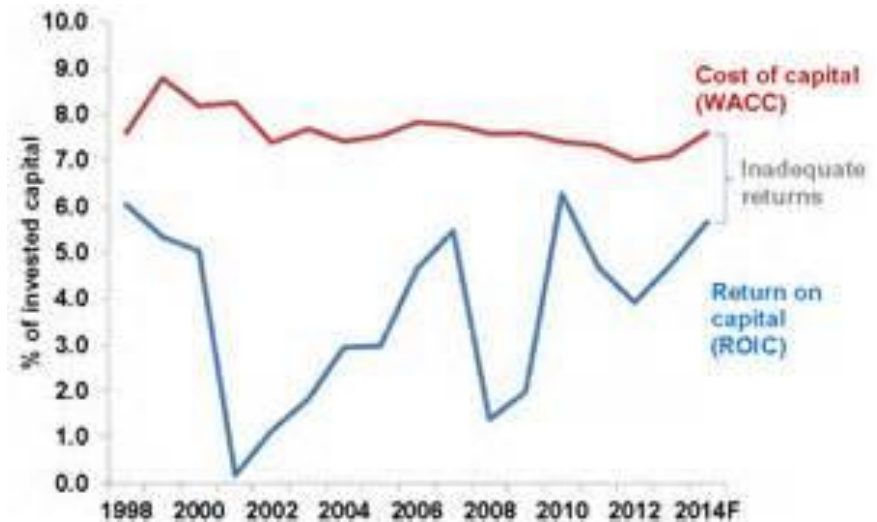


Market Realist^Q

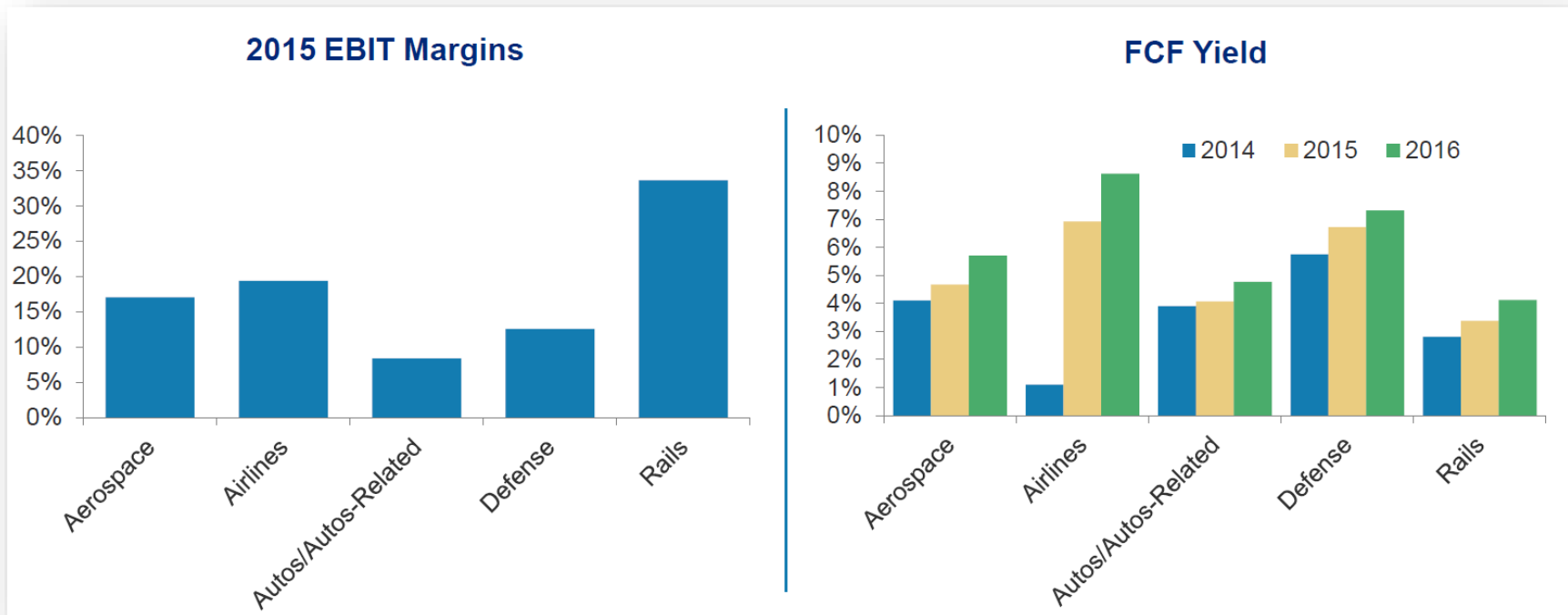
Source: IATA

- ROIC trending in the right direction, reflective of the airlines' growing discipline.

- New aircraft driving better returns, given lower unit costs and improved profitability.
- Returns on Invested Capital (ROIC) still below the airlines' Weighted Average Cost of Capital (WACC).



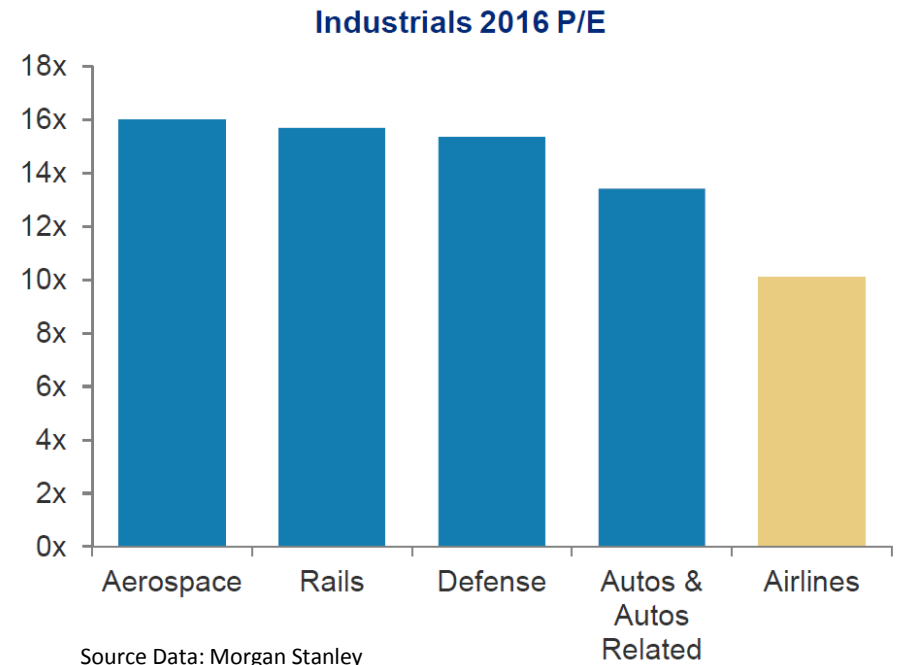
Are Airlines A *True* Industrial



- Airlines are much healthier, but investors remain skeptical. Why? A highly cyclical industry, with the volatility in earnings compounded by more of a consumer versus industrial customer base, significant operating leverage (fixed costs) and historically high financial leverage.
- Margins now middle of the pack, with superior cash flows. Hence the greater return of capital to shareholders by way of dividends and share buybacks.

Investor Skepticism Reflected In Share Valuations

- Given track record and rational behaviour, an argument could be made that the airlines should trade in line with industrials.
- What drives airline earnings and valuations?
 - the macro environment (GDP incl. expansion, contraction and shocks)
 - capacity growth
 - unit revenue (RASM) and demand trends
 - foreign exchange (FX)
 - oil prices
 - operating margin expansion and compression, including cost savings
 - EPS revisions
 - capital returns, like dividends and buybacks
 - Seasonality
 - other exogenous shocks, e.g. war



Golden Age Of Aviation Left Behind In Contrails



= Yesterday

Today =



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Golden Age For Aviation Investors ...

➤ To recap, *what has changed*:

- *Greater capacity discipline* to ensure revenue optimization between load factors and ticket prices, as well as ensuring strong revenue management through a balanced mix of fare buckets.
- Significantly *greater focus on unbundling and charging à la carte* for items such as baggage fees, commissions on travel-oriented services like car rentals and hotels, and the sale of frequent-flier points.
- *Fleet renewal to lower unit costs*, with carriers up-gauging to larger and more fuel-efficient aircraft to ensure economies of scale through more seats per departure and longer stage lengths.
- *Ongoing densification of the cabin* through tighter seat pitch, new slim-line seats and other measures.

Golden Age For Aviation Investors ...

The List Goes On

- *Consolidation has re-balanced power in the supply chain, with the remaining carriers utilizing their market power to strike deals with manufacturers, financing sources, MRO shops and other suppliers, employees, with the government's blessing, distribution channels and customers.*
- *Legacy carriers taking a page out of the low-cost carrier playbook to drive unit costs, excluding fuel, to lower sustainable levels.*
- *Witnessing some convergence in unit costs between legacy and low cost carriers as fewer legacy players in a consolidated industry leverage scale and strength, as well as discipline, to close the gap with LCCs, many of which have hit a market share ceiling and are morphing their offerings to look more like legacy carriers.*
- *Oil prices hold a larger share of costs today, which implies today's low oil prices should have a greater impact, as we have witnessed.*
- *Balance sheet liquidity and cash flow profiles are improving at a rapid rate.*
- *Witnessing improving return on invested capital, although still work to do.*



The Murray Wealth Group (MWG) is a private client wealth management firm offering discretionary investment management services to individuals and families. MWG is a long-only, growth-oriented equity manager offering five strategies, including four equity funds and one fixed income fund, which are constructed to deliver strong absolute returns.

Our flagship strategy is the MWG Global Growth Equity Fund, which focuses primarily on large cap equities with a developed markets footprint. The majority of the stocks in this portfolio are best-in-class global companies. We also offer the following strategies: US Growth Equity, Canadian Growth Equity, Dividend Growth and Fixed Income. Our solutions are available to investors on either a segregated basis or through investment in units of the respective pooled funds (US Growth Equity not available on a pooled basis at this time).

The Murray Wealth Group offers unique, personalized solutions, driven by our depth of knowledge and long-term experience. We believe in partnering with our clients to understand and appreciate their long-term goals and commit to achieving their success.

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