HIGHLAND CAPITAL MANAGEMENT

U.S. Airlines: Can The Bull Market Continue?

September 2014

We believe that positive tailwinds will persist and that current valuation levels could provide an attractive return.

Industry Trends

We believe that positive tailwinds will persist and that current valuation levels could provide an attractive return. Industry consolidation combined with higher fuel prices and financially-focused management teams have all been contributing factors to the ongoing environment of domestic capacity constraint. Gone are the days when Delta would attempt to steal market share on the Dallas to Chicago route, and American would retaliate by adding a bunch of capacity between Atlanta and New York. There is finally an appreciation of the greater good that can be achieved by rational decision-making, and the benefit of this capacity constraint is becoming evident.

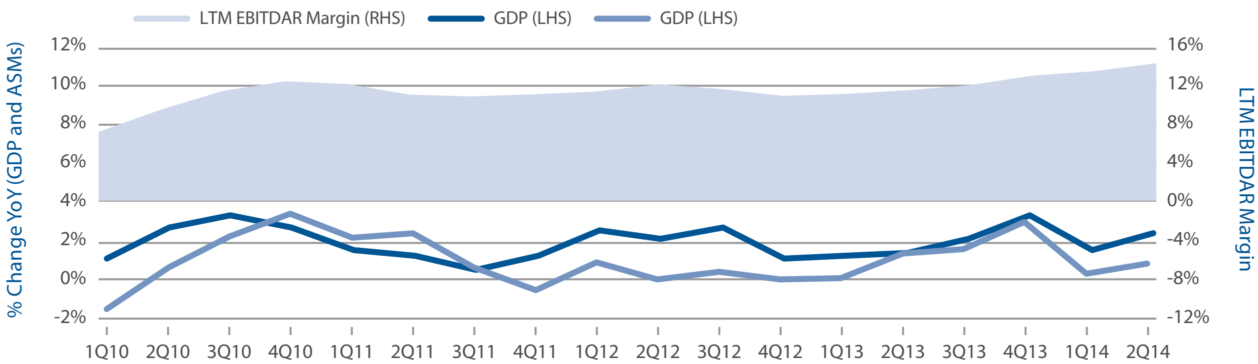
As shown in figure 1, domestic capacity growth has remained below that of GDP for the past three years. This combined with the three major carriers now controlling about 75% of the market has helped them to produce substantial profitability growth. The recent lackluster performance at United actually masks the improvement at American and Delta, whose LTM margins are at or over 16% as of the second quarter, and obfuscates the progress and momentum within the industry.

There is finally an appreciation of the greater good that can be achieved by rational decision-making, and the benefit of this capacity constraint is becoming evident.

American is still in the midst of a merger and an internal restructuring under new management that, once completed, will position it alongside industry-leading Delta as the two premier domestic network carriers. Against the favorable industry backdrop, we also find JetBlue interesting given a number of revenue enhancement opportunities that management has thus far eschewed but that investors are more vociferously demanding.

American Airlines		JetBlue	
Ticker	AAL	Ticker	JBLU
Market Cap ($mm)	$ 28,170	Market Cap ($mm)	$ 3,612
Dividend Yield	1.0%	Dividend Yield	0.0%
Current Price (as of 9/03/14)	$ 39.12	Current Price (as of 9/03/14)	$ 12.38
Target Price	$ 53.00	Target Price	$ 15.50
1-year Total Return Potential	**37%**	**1-year Total Return Potential**	**25%**

Figure 1: GDP and Domestic ASM Growth versus Network Carrier EBITDAR Margins



Source: Bloomberg, Morgan Stanley research reports, U.S. Department of Transportation

What Else Has Happened

Another positive factor has been the reduction of labor constituencies (via consolidation) and the relative harmonization of labor costs (via court restructurings). In regard to cost structures, network carriers are on a more even playing field than ever before. One of the more forgotten facets of the pre-crisis industry was the role that Southwest (the other major, or "ankle-biter" according to some airline executives at the time) played in price setting, which was largely attributable to its substantial fuel hedge portfolio as prices began to escalate. For example, more than 90% of its consumption was hedged at a crude oil equivalent price of $50 per barrel in 2007, a year in which WTI averaged $96. Southwest set the price on

All of these factors have contributed to creating an industry that is more disciplined, cost competitive, and profitable than at any time in its history, and there is no reason to believe that it cannot persist and be improved upon during the near-term.

competitive routes, and the legacies would typically follow suit. However, that fuel price advantage has essentially disappeared, and the company is now battling non-fuel cost creep due to its labor contracts and expansion into more primary airports. One is now hard-pressed to find those really low priced fares that were once ubiquitous at Southwest.

Furthermore, all carriers have made significant strides in fare unbundling and ascribing value according to customer needs. These ancillary revenues typically have little costs associated with them and, thus, provide a direct benefit to the companies' bottom lines. All of these factors have contributed to creating an industry that is more disciplined, cost competitive, and profitable than at any time in its history, and there is no reason to believe that it cannot persist and be improved upon during the near-term.

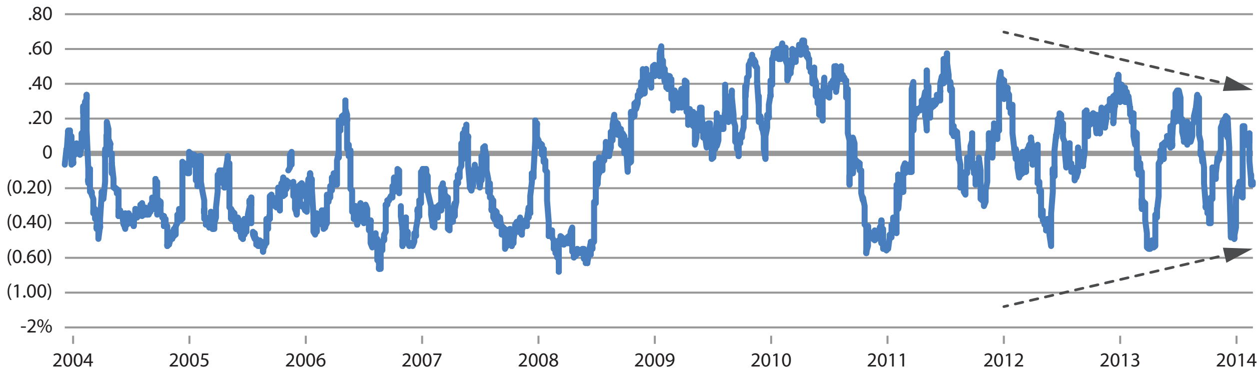
Fuel Pricing

Besides the structural changes that the industry has experienced, we believe that crude prices could serve as a catalyst for improved profitability due to the current airline supply/demand environment and the period of fare price rigidity that is likely to follow if fuel prices decline. Domestic crude production growth remains substantial, and there is now even talk of what has been considered verboten – allowing limited amounts of crude exports. This "Energy Renaissance" coupled with lower emerging market demand growth and increasing energy liberalization in places like Mexico could lead to lower, or at least stable, global oil prices going forward. The old adage in investing is that airline equities go down when oil goes up and vice versa. This is not difficult to

Domestic crude production growth remains substantial, and there is now even talk of what has been considered verboten – allowing limited amounts of crude exports

comprehend given that 30-40% of airlines' operating costs is traditionally related to fuel. One can see this historical relationship during the 2004 to 2009 period in figure 2. Once

Figure 2: Correlation between Bloomberg U.S. Airlines Index and Brent Crude



Source: Bloomberg

the economy began to recover, the relationship reversed, as higher crude prices were viewed through the positive lens of being driven by increasing demand and economic activity. For the past three years, correlations have generally been mixed, which is partially attributable to the increase in geopolitical events, especially in the Middle East, that have led to crude price spikes and fears over reduced air travel demand. However, the most intriguing aspect of this data is how we have begun to enter a period of mostly negative correlations and how the absolute values of the correlations have decreased, which we believe is attributable to the level of consolidation and capacity-constraint within the domestic market. Thus, a period of moderating crude prices would serve as a potential catalyst for the sector.

American Airlines

Our favorite pick in the sector is American Airlines (AAL). Much has been written about the American story, but the important points bear repeating. In addition to an uncompetitive cost structure, pre-bankruptcy American was struggling to maintain corporate share as it coped with the transformation from the world's largest airline to one that was a distant third following the mergers of Delta/Northwest and United/Continental. This inferior market positioning contributed to the creation and preservation of unprofitable routes in an attempt to appeal to a corporate client base that demanded the same level of connectivity offered by American's larger competitors. The larger combined network of the new American allows these routes to be eliminated or at least operated profitably with higher loads and better yielding connecting traffic.

Another carryover of legacy American is the use of rolling hubs, where departures/arrivals are scheduled consistently throughout the day. Many carriers adopted this strategy post-9/11 as a means to reduce operating costs in the face of declining demand and rising fuel prices years later. However, due to limited industry capacity growth coupled with solid demand strength, other network carriers have transitioned back to rebanked hubs despite the higher costs, given the improved profitability that can be achieved by providing improved connecting service and arrival/departure times better suited for business traveler needs. American recognizes this opportunity and is in the process of rebanking their hubs, and the potential revenue enhancement is not insignificant (estimated to be equivalent to 2-3% of EBITDAR).

Seat density on the Boeing 737-800 and 777-200 fleets is another improvement area that American is addressing. Currently, American has 150 and 247 seats on these planes versus 160 and 291 seats at Delta, respectively (in relative terms, 6% and 15% less seats). If one flies on a current American 737, you may notice that four of the seats are physically blocked with plastic inserts because the FAA requires one flight attendant for every 50 passengers, and the cost for an additional flight attendant was considered uneconomic compared to the potential revenue for those four seats. While this may be accurate, legacy American was seemingly beholden to a minimum seat pitch on these aircraft and was reluctant to consider adding another row. The completion of this densification effort will add yet another impactful source of ratable incremental revenue over the next couple of years as the modifications are undertaken. The 737s are anticipated to be completed in two phases through the end of 2015, and the 777s are scheduled for a mid-2016 completion date.

These issues highlight the possibility that prior American management may have become complacent due to the belief that the airline's competitive disadvantages were outside their control in the absence of a formal restructuring. Now, with an invigorated US Airways management team in place, American not only benefits from their experience of having successfully navigated previous mergers but also the revenue enhancement opportunities as these aforementioned issues are addressed and the carriers are fully integrated (the single operating certificate (SOC) is still on schedule for mid-2015). Contrary to popular perception, we believe that the premier management team resides at American and not at their counterparts in Atlanta and that their capabilities are generally underestimated by the market.

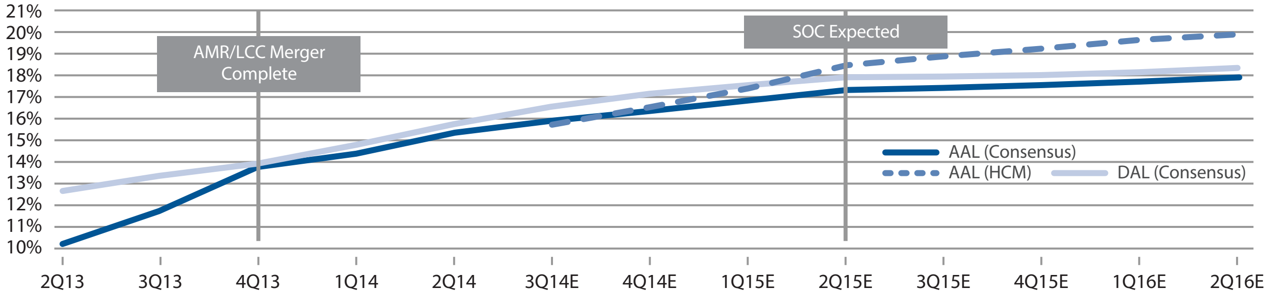
Below the revenue line, the merger-related cost savings are relatively quantifiable given known headcount and overhead reductions as well as the results from previous mergers, but it is becoming increasingly evident that management has identified incremental savings since taking over the reins. For example, the company recently announced that it had decided to outsource the publication of its in-flight magazines, and this follows management's decision in May to reduce publication in half to once monthly. Even during the post-9/11 doldrums, this division has always been held out as a pillar of profitability within the company. We wonder what has occurred to change this stance...

During management meetings, the company has also discussed their surprise at discovering a marketing budget that was $150-200mm higher than that of US Airways. It is their belief (as it is ours) that customers generally do not select an air carrier based on the name emblazoned on the stadium of their favorite basketball team. We believe that these aforementioned factors are significant cumulatively and that their potential impact as they come to fruition is undervalued by the market.

Contrary to popular perception, we believe that the premier management team resides at American and not at their counterparts in Atlanta and that their capabilities are generally underestimated by the market.

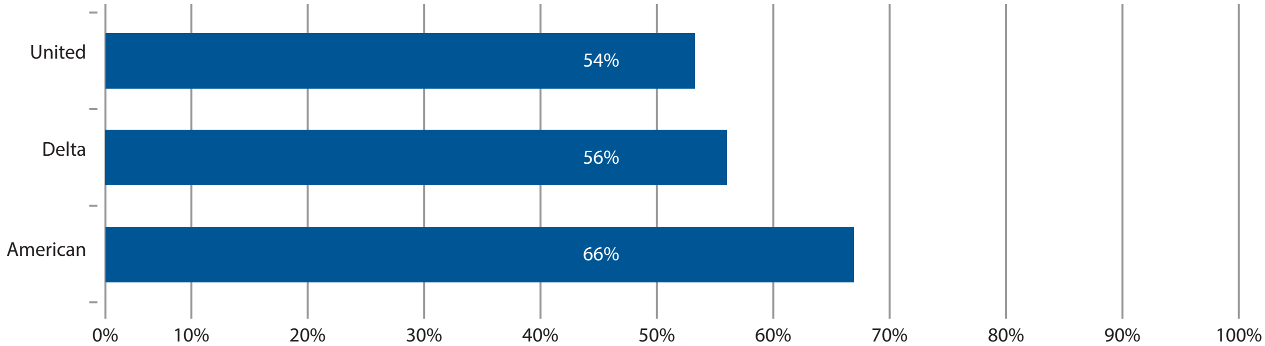
From a valuation perspective, the three network carriers trade at an average of about 6.0x consensus estimates for 2014 EBITDAR and around 5.2x 2015 figures, and these multiples are consistent with levels over the past year or so (specific multiples for American, Delta, and United are 6.0x, 5.7x, and 6.3x for 2014 and 5.2x, 5.1x, and 5.4x for 2015, respectively). However, the projected EBITDAR margin for American is about 40bps lower than that of Delta (DAL) over the next two years. The disconnect prior to complete integration is understandable, but thereafter, American's margins should at least converge and likely exceed that of Delta by an estimated 100bps given the lack of meaningful profit sharing (a union giveback during bankruptcy and merger negotiations). In fact, American's 2Q14 margin was 20bps higher. Outside of a yet to be completed integration and the Street's perception of a superior management team at Delta, we struggle to identify a structural deficiency within American that would drive margin underperformance. As illustrated in figure 3, we believe that this margin gap will narrow over the next four quarters and that American's margin will begin to exceed that of Delta once the benefits of the completed integration and revenue enhancement initiatives begin to accrue. Assuming a modest premium to Delta's 2015 margin and a 6x multiple yields a share price of $53, roughly 35% upside from current levels.

Figure 3: LTM EBITDAR Margins—AAL and DAL



Source: Bloomberg, Highland Capital estimates

Figure 4: Domestic ASMs (% of Total, LTM July 2014)



Source: Company traffic releases

AAL Recent Weakness

Following 2Q results, we believe that much of American's weakness versus its peers stems from lowered PRASM guidance driven by the reduction in Venezuelan capacity due to currency repatriation issues. While we acknowledge the high yields in this market, management is taking the appropriate steps to reduce exposure, and they are confident that the revenue loss will be compensated by other enhancements within the network. Even if one chooses to disregard this as management optimism, the Venezuela impact will disappear from a year-over-year comp basis as we move into the second half of 2015, just about the same time that the single operating certificate is expected.

We believe that many of these aforementioned factors remain underappreciated by the market and that American is the preferred name to own in the space, particularly given its relatively higher exposure to the capacity-constrained domestic market.

There have been other concerns about the company's capacity growth. A portion of this growth is attributable to the refleeting process that will not only lower maintenance and operating costs (especially as the number of 50-seat regional jets is reduced) but will also add more competitive and appropriately-sized aircraft into many business markets. The other portion of the capacity growth is largely being driven by aircraft densification efforts and expanded service into Asia, a region where American's presence is deficient vis-à-vis its competitors. These initiatives will not only drive incremental revenue but will also help to control unit operating costs. We believe that many of these aforementioned factors remain underappreciated by the market and that American is the preferred name to own in the space, particularly given its relatively higher exposure to the capacity-constrained domestic market. We would view any bouts of weakness as a buying opportunity.

Jet Blue

We believe that JetBlue (JBLU) also represents a compelling investment opportunity, as there are still several levers that the company can pull to improve financial performance going forward. JetBlue has always attempted to distinguish itself from other so-called low cost carriers by offering a better product to its customers (e.g., DirecTV, more legroom throughout the cabin, no fee for first checked bag, free Wi-Fi, leather/e-leather seats throughout the cabin). However, it's questionable whether customers actually value all these amenities, as their total RASM (stage length-adjusted) performance is better than no-frills Southwest but lags that of domestic peers Alaska and Hawaiian Airlines by a sizeable 3.3¢ and 1.4¢, respectively.

Besides Southwest, JetBlue is the only domestic airline that does not impose a fee on the first checked bag, and thus, this seems to be a relatively easy change with minimal customer disruption. With regards to density, JetBlue's fleet contains some of the least dense aircraft in the world. Management will expound about the customer value perception, but American proved years ago that "More Room Throughout

Coach" was not a profitable strategy because that value perception was not shared amongst all passengers. Hence, most network carrier aircraft are now configured with only a portion of the cabin with more legroom.

The final revenue enhancement opportunity appears to lie with their new Mint premium transcon product. While an introductory fare strategy may be driving the differential, the Mint fares appear to be at a substantial discount to competing fares and at times to their own refundable coach fares. Regardless of whether the fares are introductory, pricing normalization will provide an incremental benefit.

Taken together, it is estimated that correcting these issues could equate to almost $0.50 in earnings per share or $280mm in EBITDAR. Assuming only half of this benefit at JetBlue's forward P/E and EV/EBITDAR multiples (currently consistent with the average of those at Alaska and Southwest) would equate to a share price of $15 to $16, 20% to 30% upside from current levels. While the current CEO has been opposed to instituting many of these changes, the probability of him being replaced has recently increased following the release of a May Bloomberg report that discussed potential succession planning as he weighs whether to request a contract extension when it expires in February. It should be noted that the company has recently announced it will begin to roll out bundled fare offerings during the first half of 2015 that will serve as a step towards baggage fee monetization and is considering some type of business sponsorship to offset the cost of their W-Fi product. However, irrespective of whether the CEO stays and these initial steps are completed, we expect the drumbeat of change to continue intensifying until all profitability enhancements are undertaken and investors are satisfied that the company is no longer leaving money on the table.

"[1] Includes Highland Capital Management and its affiliate advisers"

HIGHLAND CAPITAL
MANAGEMENT

300 Crescent Court
Suite 700
Dallas, TX 75201
Phone: 972-628-4100
Fax: 972-628-4147

DALLAS NEW YORK SINGAPORE SEOUL SÃO PAULO

20TH ANNIVERSARY 1993 20 2013 CELEBRATION