

## **The Outlook for Airlines in 2021**

**Jake Siewert:** This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries, and the global economy. I'm Jake Siewert, global head of corporate communications here at the firm. Today we're talking about the outlook for the airline industry, which has been under the gun, with Catie O'Brien of Goldman Sachs Research. We had Catie on the podcast in January of 2020, which feels like a lifetime. At that point we never could have predicted everything that's happened over the course of the past year that has transformed the airline industry and the world in general. So Catie, welcome back to the program.

**Catie O'Brien:** Thanks for having me, Jake.

**Jake Siewert:** Hopefully when we have you back next the world will look a little more sane, but clearly airlines have been one of the hardest hit sectors from COVID-19. Give us some context for how demand has fallen over the past year.

**Catie O'Brien:** Yeah, sure. So COVID has had the largest impact on air travel we have on record across the different data sets that we looked at. So turning back to last year, demand essentially fell off a cliff as COVID cases started to rise in the US with passengers going from down 30% year over year in mid March to the down mid 90% range by the beginning of April. The bottom then lasted through the end of May with the month of June, while a little better, was still down 80%.

And just for some context, Jake, in the months following September 11th, demand in North America was down about 30%. So a much more material impact in the wake of COVID-19. And turning to today, demand has recovered further, but the recovery remains fairly muted with passengers down just under 60% over the last week.

**Jake Siewert:** So obviously that's a pretty grim picture on the demand side. How has that flowed into revenue and profitability for the airlines?

**Catie O'Brien:** Sure, yeah. So the lack of demand in 2020, not surprisingly, has had a very adverse impact on airline financials. So as of third quarter 2020 actuals, revenue is down just over 60% year over year. Similar to the year to date decline in demand. The impact of profits was even greater as the airlines are still relatively high fixed cost businesses,

even though as we talked about the last time I was on your podcast, Jake, the proportion of fixed costs pre COVID were lower than it was historically for the industry but still fairly high level of fixed cost.

So the combined result was that year to date through the third quarter of 2020, the airlines lost just over \$24 billion on an adjusted basis. And that compares to net income have over \$11 billion for the first three quarters of 2019.

**Jake Siewert:** Okay. So obviously those losses are pretty staggering. How have the airlines been financing those losses?

**Catie O'Brien:** Yeah, so the airlines have received substantial government aid to offset losses both in the form of grants to pay employees and the option to apply to a secured loan program but have actually raised more cash through the capital markets. Since March, the airlines have raised \$54 billion via the public debt capital markets and just under \$7 billion from new equity issuance.

**Jake Siewert:** So talk a little bit about the stimulus support. How much did the airline industry get? And how much did those relief packages mean for the airlines last year?

**Catie O'Brien:** Yeah, so under the CARES Act in 2020, the airlines received \$25 billion under the payroll support program. 70% of those funds were in the form of grants that do not need to be repaid, but the remaining 30% in the form of low-interest, long-term unsecured loans. And then also under the 2020 CARES Act, the airlines were able to apply to a 5-year secured loan program that had pretty attractive rates versus the prevailing market rates.

The government made an additional \$25 billion available to the industry under this program, but not all airlines ultimately decided to participate. Now roll forward to this year. The government has once again allocated the airlines additional funds under the broader Relief Act with the government allocating 15 billion in payroll support to the airline industry this year. This comes with the condition that airlines need to call back employees that were furloughed after the expiration of the first payroll support program back at the end of September last year. And the government is still in the process of allocating those funds to each airline.

**Jake Siewert:** So what are airlines doing to entice people back

into flying? I know the whole travel industry is sort of rethinking its marketing efforts. What are airlines trying to do to get people comfortable flying again? And what's proving most effective?

**Catie O'Brien:** So all the airlines have stepped up their cleaning protocol, adding elements that I've never heard of before until this year like spraying the interior of the aircraft with antimicrobial mist in addition to just their normal cleaning procedures. And the airline teams have been working to educate the public on the high level of cleanliness they held themselves to even prior to COVID. So, for example, airlines have always had HEPA filters [UNINTEL]. That means the air in the cabin is completely refreshed every 2-3 minutes. This hasn't been something you would typically hear on an earnings call from airline management teams, but over the last nine months it has. Additionally, many airlines have new safety and cleaning information available on their websites. Many have made efforts to spread the word through media outlets like *Good Morning, America*, for example.

And then I should also add that while the scientific community was still in the process of doing research on the spread of COVID, most airlines adopted a blocked middle seat strategy as an added precaution. Now that institutions like the department of defense among others have published research on COVID and flying, most US airlines actually stopped blocking the middle seat, except Delta which continues to do so.

In terms of effectiveness, it's hard to say what has built consumer confidence because at the same time they've been rolling out these efforts in terms of cleaning, media blitzes, etc., we've also had cases rising in the US. But I would highlight that we have seen passenger demand in the US improve, albeit modestly, from September to today even as COVID cases continue to hit new highs.

**Jake Siewert:** So we talked last year about consolidation, which has been a pretty big trend in the industry. Has the pandemic stopped that consolidation, or are there still signs that the industry is consolidating?

**Catie O'Brien:** So since we spoke last year there haven't been any incremental attempts at consolidating the industry even driven by the negative impacts of COVID on the industry. Just as a reminder, the last merger we had between the publicly traded US airlines was back at the end of 2016 when Alaska

acquired Virgin America. Haven't really heard any rumblings since. That's not to say there couldn't be future opportunities for further consolidation, although I suspect it would likely be amongst some of the smaller airlines as the top four players already hold over 80% of domestic market. So it might be tougher to get done from a regulatory standpoint.

**Jake Siewert:** Okay. So vaccines are on the horizon today in reality in some places for some people anyway. What's the outlook for the industry this year given the prospect of putting COVID at least in a more manageable place?

**Catie O'Brien:** Yes, fingers crossed. So we are forecasting that demand for 2021 will still be about one third less than what we saw in 2019. However, that's a function of lower first half of 2021 demand while the population is still in the midst of being vaccinated with a sharper recovery in the second half the year. Our current forecast for the fourth quarter exit rate of 2021 is that demand will be down a lesser 20% versus the same period in 2019.

**Jake Siewert:** What's the outlook for the industry more medium and longer term if we look ahead? Will things go back to normal? Or do you think we'll see a significant shift in business models, in the services and products that the airlines are offering?

**Catie O'Brien:** Yeah, so in the short term, I think we could see a slowdown to some innovation on both the consumer-facing side and internal systems as airlines focus on paying down debt raised to get them through the COVID downturn, which could delay some medium-term plans as well because of that short-term spending freeze. But, you know, over the medium term, I do think it will take some time for the airlines to get back to pre COVID levels of profitability due to the increased debt load I just mentioned in addition to what I expect will be lower ticket prices over the next couple of years. My assumption on those lower ticket prices is really driven by two things. First, a slower recovery from corporate travelers who usually pay higher prices for last-minute bookings than leisure travelers. And then secondly, a period of what I expect will be more intense competition as demand will take some time to fully recover. I'm forecasting it will take until 2023 for demand to fully rebound to 2019 levels. But for the most part, I think things will go back to, you know, quote/unquote, normal with respect to product, business models, and eventually that level of profitability.

And I guess one thing I should mention on the product side that has changed that consumers should be happy about is that we have some airlines do away with change fees for most fare classes. This was initially to give consumers confidence in booking given fluctuation in COVID trends, in travel restrictions. So we'll have to stay tuned to see if this evolves.

**Jake Siewert:** So Catie, we don't usually talk individual companies here, but it's hard to talk about the airline industry without talking about the Boeing 737 Max. What's the latest there? It was grounded for a bit last year, but it has been approved to fly again. What do you see for the future given the demand dynamics that we've been talking about?

**Catie O'Brien:** Yeah, so that's right. So back in mid November of 2020 the FAA lifted the grounding that had been in place since March 2019. And back when we spoke last year, I would have thought that would have been a much more momentous occasion in the airline industry had it not occurred in the midst of a global pandemic. So then, you know, looking forward, you know, my colleagues in the global investment research department that cover Boeing recently published that the backlog of orders for the Max was only down 13% from the pre-grounding high.

And then looking at the US airlines that I cover, while some have pushed out delivery dates for the Max and other aircraft types due to COVID, none have canceled Max orders. And in fact, we recently saw Alaska add to its max order. And then high level, you know, you're right, while demand is lower and the airlines therefore need fewer aircraft over the short to medium term, we have seen many airlines in the US look to speed up retirement of older aircraft to help bridge this gap versus solely looking to cancel or push back delivery of new aircraft.

In fact, my team and I recently completed an analysis that shows that the US airlines have retired 8% of their 2019 fleet. But by the end of 2021 are taking deliveries of new aircraft to the extent where the year-end 2021 fleet will only be 2% smaller than the year-end 2019 fleet. So really leaning on retirement of older aircraft to help right size that US fleet versus necessarily pushing back deliveries of new aircraft, although there has been some right sizing of order books.

**Jake Siewert:** All right. Well, Catie, hopefully when we have you on next the world will look different and the industry will be healthier, but thanks for joining us today.

**Catie O'Brien:** I hope so. Thanks so much for having me, Jake.

**Jake Siewert:** That concludes this episode of Exchanges at Goldman Sachs. Thank you very much for listening, and if you enjoyed this show we hope you subscribe on Apple Podcasts and leave a rating or a comment. And please tune in later in the week for our weekly markets update where leaders around the firm give a quick take on what they are watching in markets. This podcast was recorded on Tuesday, January 12th, in the year 2021. Thank you very much for listening.

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